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No. 80-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

GEORGE W. FULK, THOMAS W. SHELTON,
AND WILLIAM F. SUDDETH,
Petitioners,

v.

DAVID R. JOHNSTON, THE NORTHWESTERN BANK,
AND JAMES R. GILLEY,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether the trustee of a corporation in reorganization may assume the reasonable and necessary costs, exclusive of attorneys' fees, of an action brought by employees of the corporation against fiduciaries of their employee benefit plans for substantial violations of the Employee Retirement Income Security Act of 1974 ("ERISA")?

2. Whether the trustee of a corporation in reorganization that arguably is guilty of direct and active breaches of its fiduciary obligations under ERISA may assist the corporation's employees in bringing a lawsuit against the parties directly responsible for the losses sustained by their employee benefit plans in an effort to eliminate its own liability for such breaches?

3. Whether the trustee of a corporation in reorganization who has uncovered breaches of duty by fiduciaries of the corporation's employee benefit plans may assist employees in bringing a lawsuit in an attempt to eliminate claims against the corporation for co-fiduciary liability under ERISA?

4. Whether the trustee of a corporation in reorganization who has uncovered breaches of duty by fiduciaries of the corporation's employee benefit plans may, under the Bankruptcy Act, assist employees in bringing a lawsuit in an attempt to eliminate claims against the corporation?

PARTIES TO THE PROCEEDING

George W. Fulk

Thomas W. Shelton

William F. Suddeth

Webster A. Collins*

Herbert R. Morrison*

Helen O. Morrison*

W. O. Gregory

Glen A. Wilkinson*

R. A. Gilbert, Trustee**

David R. Johnston

The Northwestern Bank

James R. Gilley

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* The indicated parties are petitioners in a separate, but related, petition for a writ of certiorari which is being filed simultaneously with this petition. Although the petitions raise some similar issues, there are significant differences between the two, primarily due to the fact that the instant petition is being filed by employees of The Washingon Group, Inc., while the other is being filed by its shareholders.

** As the Trustee in reorganization of The Washington Group, Inc. and its subsidiaries, R. A. Gilbert joined in the proceeding below but is not involved in the filing of this petition.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

George W. Fulk, Thomas W. Shelton, and William F. Suddeth hereby petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fourth Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fourth Circuit (Appendix A) has not been reported. The opinion of the United States District Court for the Middle District of North Carolina (Appendix B) is reported at 476 F. Supp. 246 (M.D.N.C. 1979). Various other orders of the courts below are set forth in Appendices C-G.

JURISDICTIONAL STATEMENT

The judgment of the Court of Appeals (Appendix H) was entered on November 4, 1980. A timely petition for rehearing and rehearing in banc was denied on January

19, 1981 (Appendix I). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The relevant statutory provisions are set forth in Appendix J. Those provisions are §§ 3(21) and 405 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1002(21) and 1105; § 189 of the Bankruptcy Act, 11 U.S.C. § 589, recodified at 11 U.S.C. § 1108 (Supp. III 1979); and Rule 10-208(a) of the Federal Rules of Bankruptcy Procedure.

STATEMENT OF THE CASE

Petitioners are present and former employees of The Washington Group, Inc. or its wholly-owned subsidiaries (the "Companies") and participants in the employee benefit plans maintained by those corporate entities. On June 20, 1977, the Companies entered into reorganization under Chapter X of the Bankruptcy Act.[1] The bankruptcy judge appointed a reorganization Trustee, Richard A. Gilbert, and ordered him to conduct an investigation, pursuant to Rule 10-208(a) of the Federal Rules of Bankruptcy Procedure, into the circumstances which led to the Chapter X reorganization. The Trustee's report of

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[1] Chapter X, together with the rest of the Bankruptcy Act, has been superseded by the Bankruptcy Reform Act of 1978, which revised and recodified the existing federal laws relating to liquidations and reorganizations of insolvent debtors. Pub. L. No. 95-598, 11 U.S.C. prec. 101 note (Supp. III 1979). Cases commenced prior to September 30, 1979, however, are to be "conducted and determined under [the Bankruptcy] Act as if [the Bankruptcy Reform] Act had not been enacted, and the substantive rights of parties in connection with any such bankruptcy case, matter, or proceeding shall continue to be governed by the law applicable . . . as if the [Bankruptcy Reform] Act had not been enacted." *Id.* There are, in any event, no significant differences between the Bankruptcy Act and the new Bankruptcy Code with respect to the issues involved in this case. Subsequent references to the old Bankruptcy Act will be to the 1976 edition of the U.S. Code. References to the Bankruptcy Reform Act will be to Supp. III of the 1979 edition of the U.S. Code.

his investigation, which was filed on June 30, 1978, ultimately led to this litigation.[2]

In his report, the Trustee found substantial evidence of "mismanagement on the part of certain of the officers/directors of the [Companies] or others acting in fiduciary capacities," particularly in connection with the Companies' employee benefit plans.[3] Trustee's Report at 55. As the Trustee's report chronicles, "blue chip" stocks held by the Companies' profit-sharing plans had been sold precipitously in 1974 by the plans' trustee, American Bank and Trust Co. of Pa., at a loss of nearly $500,000. *Id.* at 95-96, App. K at 35a-36a. Proceeds from the sale of these "blue chip" stocks were then invested in the common stock of the Companies. That stock, which had been purchased at peak prices in an apparent attempt to inflate its market value, soon amounted to "more than 40% of the total assets of the profit-sharing plans . . .," *id.*, an amount found "unjustifiable" by the Trustee. *Id.* at 98, App. K at 35a.

Over the next year and a half, the Trustee retained the Companies' stock, even though it markedly declined in value. As a result of these and other unlawful acts, the plans sustained an additional loss of over $2 million by the time of their termination shortly before the institution of reorganization proceedings. In the Trustee's view, these actions, which ultimately caused the plans to lose approximately $2.8 million, or more than 80% of their value, in a brief, two-year period, had been "encouraged in great measure by management of The Washington

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[2] The Trustee's report is a part of the record in this case and can be found at pages 11-257 of the appendix to the appellants' brief in the proceeding below. Pertinent parts of this report are attached hereto as Appendix K.

[3] Prior to filing for reorganization, the Companies had at various times maintained three profit-sharing plans for salaried and non-salaried employees, a pension plan, and a stock purchase plan.

Group, Inc. . . ." *Id.* at 98, App. K at 37a. Finding the mismanagement of the plans to constitute "the single most callous act revealed" during his investigation, the Trustee concluded that employees of the Companies who had participated in the plans had substantial claims for breaches of fiduciary duty. *Id.*

Because many of the plan participants were still employed by the Companies, the Trustee's report recommended that they be given assistance in the prosecution of their claims. The Trustee also concluded that "[p]oor [employee] morale has been a sizable problem since the [Companies] filed for corporate reorganization. . . ." *Id.* at 98, App. *F* at 38a. He therefore determined that a suit brought by or on behalf of the plan participants to recover the losses from the mismanaged plans could "vitally" improve employee morale. *Id.* at 98-99, App. K at 38a. Accordingly, the Trustee's report urged the bankruptcy judge to authorize him to assert a cause of action on behalf of the affected employees or, in the alternative, to assist them in securing compensation for their losses. *Id.* at 98, App. K at 37a-38a. Additional authorization was sought "to expend funds of the [Companies] to assist in the prosecution of actions . . . for the recovery of losses resulting from these mismanaged profit-sharing plans . . . ." *Id.* at 98- 99, App. K at 38a.

Thereafter, the Trustee formally applied for and obtained an order from the bankruptcy judge authorizing the Trustee "to assist the affected employees in securing compensation for their losses arising on account of [the] mismanagement" of the plans. Order dated July 21, 1978 (Appendix D). Relying on this order and the Trustee's stated willingness to defray the costs of an employee lawsuit, certain present and former Washington Group employees—the petitioners before this Court—filed a civil class action, *Fulk* v. *Bagley*, No. C-78-332-WS, in the United States District Court for the Middle District of

North Carolina on July 26, 1978 (amended complaint filed August 15, 1978). That action charged former officers and directors of the Companies, as well as the banks named by them to serve as trustees and custodians of the plans, with violations of the Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001-1381 (1976 & Supp. III 1979), the federal securities laws, and the common law, through their flagrant manipulation and mismanagement of the employee benefit plans maintained by the Companies.[4] Two of the defendants in that action—defendants Gilley and Northwestern Bank—are respondents in the instant case.[5]

Following the institution of the lawsuit, the Trustee filed an application with the bankruptcy judge, seeking express reconfirmation of his authority to expend the funds of the Companies for costs, other than attorneys' fees, incurred in the prosecution of the *Fulk* action. In his application, the Trustee observed that his assistance in the *Fulk* case was based on the bankruptcy judge's prior order and stated:

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[4] In addition to violations based on the facts described in the Trustee's report, the *Fulk* amended complaint alleges that the defendants, including respondents Gilley and Northwestern Bank, caused the assets of the plans to be invested in stock of less than a fiduciary quality for the purpose of supporting the over-the-counter price of Company stock at artificially high levels, failed to review the investment of plan assets in Company stock during a period in which the value of such holdings was declining drastically, and engaged in other acts of self-dealing, fraud, and mismanagement.

[5] The defendants in the *Fulk* case are Smith W. Bagley, a former shareholder, officer, and director of the Companies; James R. Gilley, a former officer and director and a present shareholder of the Companies; American Bank and Trust Co. of Pa., the trustee of the profit-sharing plans and custodian of the stock purchase plan; and The Northwestern Bank, the trustee of the pension plan and the successor to American Bank as trustee of the profit-sharing plans.

> The assistance and morale of the employees are essential ingredients to any successful plan of reorganization and to the financial rehabilitation of the [Companies]. In addition to the obvious uncertainties inherent in any reorganization proceeding, these employees have seen their hard-earned employee pension, profit-sharing, and stock-purchase benefits and investments reduced substantially.
>
> . . . To the extent that the employees have been damaged by virtue of the manipulations and mismanagement as are more particularly alleged in the two class actions, they are potential claimants in these reorganization proceedings. The successful prosecution of these actions and recoveries thereunder would negate the necessity of your Applicant's having to deal with the employees as claimants within the context of a plan of reorganization.

Application for Authority to Expend Funds for Costs in Plenary Class Actions, filed on January 15, 1979. The bankruptcy judge agreed and entered an order granting the application on January 16, 1979 (Appendix E).

Thereafter, the respondents herein, in their capacities as shareholders or creditors of the Companies, sought review in the district court of the bankruptcy court order of January 16, 1979.[6] In an effort to block the expenditure of the Companies' funds in the prosecution of the lawsuit against them, the respondents argued that this Court's decision in *Caplin* v. *Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972), precluded the Trustee from providing any financial assistance whatsoever to the class action plaintiffs.

On September 5, 1979, the district court agreed. *In re Washington Group, Inc.*, 476 F. Supp. 246 (M.D.N.C.) (Appendix B). Although it recognized that *Caplin* concerned the " 'Trustee's standing to sue, not . . . the

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[6] In the court below, petitioners unsuccessfully opposed respondents' appeal from the January order on timeliness grounds, but they do not seek certiorari as to that issue.

appropriateness of litigation-related expenditures which may benefit the estate,'" App. B at 13a, the district court held that the "rationale of the Court's holding in *Caplin*" was controlling. *Id.* at 14a. In its view, *Caplin* stood for the proposition that a trustee "may only bring actions and expend funds on behalf of the estate." *Id.* at 12a. Reasoning that the Trustee could not do indirectly what *Caplin* prohibited him from doing directly, the district court concluded that the expenditure of funds on the class action would not be an act "for the direct benefit of the estate." *Id.* at 14a. The district court, therefore, vacated the bankruptcy court's January 16, 1979 order and directed it to enter an order denying the Trustee's request for authority to use corporate funds in support of the employees' action. On appeal, the Fourth Circuit affirmed per curiam on the basis of the district court's opinion.[7] Appendix A.

Prior to the district court's ruling prohibiting the Trustee from defraying the costs in *Fulk* v. *Bagley*, the employees' class action had been proceeding with the Trustee's assistance. The plaintiffs had filed a motion for class certification, and the defendants had filed motions to dismiss. Shortly after the ruling on the costs issue, the defendants' dismissal motions were denied on the ground that plaintiffs had stated valid claims under ERISA.[8] *Fulk* v. *Bagley*, 88 F.R.D. 153 (M.D.N.C.

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[7] In the meantime, petitioners filed multiple proofs of claims and other documents in the Chapter X proceedings, seeking to preserve the rights of all employee participants in the plans to recover their losses from the Companies. Although the bankruptcy judge has to date denied the petitioners any right to participate in the Chapter X proceedings, his order excluding their claims has been appealed to the district court not only by the petitioners but also by the Securities and Exchange Commission.

[8] The court also refused to dismiss the plaintiffs' claims based on the federal securities laws and the common law of North Carolina.

1980) (Appendix L). However, in so doing, the district court noted that the Trustee's inability to lend financial assistance to the employees raised questions as to their ability to bear the costs of a class action. App. L at 66a-67a. Accordingly, the decision below seriously jeopardizes the employees' ability to maintain *Fulk* v. *Bagley* as a class action, and, ultimately, their ability to obtain redress for the flagrant misuse of their retirement funds.

REASONS FOR GRANTING THE WRIT

This petition raises important questions with regard to the interaction of the Bankruptcy Act and the Employee Retirement Income Security Act of 1974 ("ERISA"). Relying on this Court's decision in *Caplin*, the courts below held that the Bankruptcy Act precluded the trustee of a corporation in reorganization from expending corporate funds to assist the corporation's employees in the prosecution of an action to vindicate their rights under ERISA. This holding ignored the fact that the Trustee, as an ERISA fiduciary, had both the right and the duty to take remedial action to correct the various abuses that had destroyed the financial viability of the employees' benefit plans. If not reversed, the decision below may seriously erode the protections available under ERISA to employees of employers in reorganization, just at a time when the increasing number of business failures have made those protections of paramount importance.

Moreover, the courts below ignored the point that the corporation itself faced potential fiduciary liability under ERISA not only due to its selection, appointment, and inadequate monitoring of the parties directly responsible for the plans' losses, but also due to the active participation of corporate management in the actions which led to those losses. By offering to pay the costs, exclusive of attorneys' fees, of a class action against the malfeasors,

the Trustee sought to avoid huge potential liability and extensive litigation expenses that might have depleted the estate. The holding below precludes the Trustee from taking action which is protective of the estate and consistent with his fiduciary duties under ERISA.

Petitioners submit that these consequences are neither mandated by, nor consistent with, the Bankruptcy Act or this Court's decision in *Caplin*. This Court, therefore, should grant certiorari to correct the lower courts' unduly restrictive interpretation of the Bankruptcy Act and harmonize that statute with the important policies and mandates of ERISA.

1. The courts below endorsed an unduly narrow interpretation of the Bankruptcy Act that will seriously undermine the rights of participants of employee benefit plans and vitiate the statutory obligations of fiduciaries under the Employee Retirement Income Security Act of 1974.

Under ERISA, the responsibility for the management of employee benefit plans and the investment of plan assets is in the hands of the plan's fiduciaries. The term "fiduciary" is defined by ERISA to include any person who exercises discretion or control with respect to a plan.[9] The broad scope of this definition has been recognized by the courts. *Eaves* v. *Penn*, 587 F.2d 453 (10th Cir. 1978). There is no doubt that a corporation and/or its officers may be fiduciaries within the meaning of ERISA. 29 C.F.R. § 2509.75-5, Question FR-3.

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[9] ERISA § 3(21)(A), 29 U.S.C. § 1002(21)(A), provides in pertinent part:

> a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

Here, the Companies, as employers and plan sponsors, were ultimately responsible for the establishment and the management of these plans. Moreover, they had actually exercised their fiduciary authority in several ways.[10] The Companies, acting through the Board of Directors, established the plans and selected and appointed the plan trustees, custodians, and other fiduciaries. The Companies also had the authority to direct the investment of plan assets and, in fact, influenced the plans' investment in Washington Group stock. Indeed, the Trustee's report concluded that "American Bank's actions in selling the blue-chip stocks and bonds and in purchasing The Washington Group, Inc. stock were encouraged in great measure by management of The Washington Group, Inc., and that, as a condition to its appointment as trustee, American Bank agreed to invest a large percentage of the [plans'] assets in the stock of The Washington Group, Inc." Trustee's Report at 97-98, App. K at 37a.

As fiduciaries under ERISA, the Companies were responsible for any losses suffered by the plans as a result of their own breaches of fiduciary duty. ERISA § 409, 29 U.S.C. § 1109 (1976). Here, they were guilty of several such breaches inasmuch as they, *inter alia*, had appointed the plan trustees and custodians directly responsible for the plans' losses; encouraged those fiduciaries to sell the plans' "blue chip" investments and acquire Washington Group stock; neglected to monitor the performance of the plans' other fiduciaries; and failed to take any corrective action while the value of Washington

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[10] In its decision denying the defendants' motions to dismiss the *Fulk* action, the district court observed: "It is also apparent that in defining 'fiduciary' Congress was peculiarly concerned with realities, as distinguished with mere formalities. Thus Congress determined that fiduciary status should extend to all those exercising control over employee benefit plans without regard to their office or formal relationship with the plan." App. L at 54a.

Group stock plummetted. Accordingly, the Companies faced potential primary fiduciary liability to the plan participants for their activities.

Nor was their potential liability limited to that derived from their own actions. Drawing on common law principles,[11] ERISA holds fiduciaries liable not only for their own breaches of duty, but also for the misconduct of their co-fiduciaries under enumerated circumstances that were extant here. ERISA § 405(a), 29 U.S.C. § 1105(a), provides in pertinent part:

> In addition to any liability which he may have under any other provision of this part, a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan in the following circumstances:
>
> (1) if he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach;
>
> * * * *
>
> (3) if he has knowledge of a breach by such other fiduciary, *unless he makes reasonable efforts under the circumstances to remedy the breach.* [Emphasis added].

In the circumstances of this case, the Companies, and consequently the Trustee who stood in their shoes, were under an unambiguous statutory obligation to take remedial action with respect to the mismanagement of the retirement plans. In the course of his investigation, the Trustee had uncovered abuses in the administration of these plans committed by past management of the Companies and other co-fiduciaries. Since he had knowledge of such breaches, he was obligated under ERISA

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[11] *See generally* Restatement of Trusts (Second) § 224 at 1785-92 (3d ed. 1967)

§ 405(a)(3), 29 U.S.C. § 1105(a)(3), to make "reasonable efforts under the circumstances to remedy the breach." [12] The failure to do so would have subjected him to liability for breach of this co-fiduciary obligation.

Regulations issued by the Department of Labor suggest that appropriate remedial action by a fiduciary would include the institution of a lawsuit against the wrongdoing co-fiduciaries.[13] Thus, the Trustee could have instituted a lawsuit on behalf of the plans and the employee participants. 29 C.F.R. § 2509.75-5, Question FR-10. Instead, for obvious reasons of economy, the Trustee chose, with the approval of the bankruptcy judge, to assist the employees in bringing their own lawsuit to obtain restoration of the plans' losses. This course of action arguably satisfied the obligation of the Trustee to take some action to remedy the breaches of the Companies' co-fiduciaries. At the same time, it potentially avoided the employees' claims against the estate for these losses. Moreover, because this course of action involved paying only litigation costs and not attorneys' fees, it was far more economical for the Companies' estate than if the Trustee had initiated a separate lawsuit.[14]

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[12] It is clear that the Companies' obligations under ERISA were not affected by the Companies' having entered into reorganization, the same merely having passed to the Trustee in reorganization. In re M&M Transportation Co., 2 B.R. 722 (S.D. N.Y. 1980). *See also* Kaleidoscope, Inc. Profit Sharing Plan v. Scroggins, Pension Reporter (BNA) No. 306, D-1 (N.D. Ga. 1980).

[13] Under ERISA § 502(a)(2), 29 U.S.C. § 1132(a)(2), a fiduciary is authorized to bring a civil action for fiduciary breach.

[14] In addition to these immediate savings, the Trustee avoided a variety of other expenses that might have arisen. Had the employees been successful in their claims against the estate, the Trustee might have had to institute a multiplicity of lawsuits, including suits for contribution against the wrongdoing officers and other fiduciaries.

Nonetheless, the lower courts held that the Bankruptcy Act precluded the Trustee from taking any such action to remedy past acts of mismanagement on the part of corporate officials. In so doing, the district court adopted an unduly narrow construction of the Bankruptcy Act that substantially undermines the scheme of protection afforded plan participants under ERISA. ERISA was intended to be a "comprehensive" remedial statute protecting the retirement earnings of often helpless corporate employees.[15] Preempting the common law, ERISA establishes a framework for fiduciary and co-fiduciary liability designed to ensure that persons or institutions with adequate resources will act to protect the interests of the employees against mismanagement of their plans. The district court's decision effectively holds that, once a corporation has entered reorganization in bankruptcy, it need not—indeed, cannot—act to protect the interests of employees, whether by instituting suit or assisting others in so doing.

Ironically, the district court's decision deprives the employees of the aid of the corporate fiduciary at precisely the time when it is most likely to be needed. Executives who mismanage a company to the point of reorganization often pillage the employee benefit plans as part of their actions. An impending corporate bankruptcy often provides a compelling temptation to use the assets of the employee plans to bolster the failing company—all contrary to the provisions of ERISA. The scattered and possibly laid-off employees of a company in reorganization will not have the knowledge or resources to mount an effective lawsuit to enforce their statutory rights. Yet, in this situation, the decision below holds that the trustee

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[15] International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 569 (1979). *See also* Marshall v. Kelly, 465 F. Supp. 341, 349 (W.D. Okla. 1978); Marshall v. Craft, 463 F. Supp. 493, 496 (N.D. Ga. 1978).

in reorganization cannot fulfill his fiduciary duty to take appropriate remedial action.[16]

This conclusion is not compelled by the provisions of the Bankruptcy Act.[17] While the district court assumed that the Trustee may "only act for the direct benefit of the estate," App. B at 14a, it ignored the benefit to the estate of the elimination of the employees' potential fiduciary claims against the Companies. Moreover, the district court failed to take into account a significant body of case law that recognizes a reorganization trustee's authority to expend funds of the estate for the benefit of employees and former employees, regardless of whether such expenditures will result in direct economic benefit to the estate. *See, e.g., Bowen* v. *Hockley*, 71 F. 2d 781, 785-86

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[16] These dire consequences are apparent in this case. Petitioners, ordinary employees of The Washington Group, Inc., relied on the Trustee to defray the costs of the *Fulk* action. The district court has recognized that, in the absence of a commitment from the Trustee, petitioners may not be able to fund the class action. App. L at 66a-67a. Ironically, petitioners' reliance upon the Trustee's assistance in the civil action may also result in the forfeiture of their claims in the reorganization proceedings. The bankruptcy judge has ruled that the employees are not entitled to pursue their claims in the Chapter X proceedings because their acceptance of the Trustee's assistance estops them from proceeding against him. As noted above, this ruling is currently before the district court on appeal.

[17] Under federal bankruptcy law, "the chief purpose of corporate reorganization is to preserve, if possible, the going-concern values of the debtor in contrast to the forced sales and depressed values of outright liquidation. If this is to be done, the debtor's business must be maintained in operation." 6, pt. 2 Collier on Bankruptcy ¶ 8.12 at 1420 (14th ed. 1978). Consequently, § 189 of the Bankruptcy Act gives a reorganization trustee the authority to continue to operate the business. 11 U.S.C. § 589 (1976); *see* 11 U.S.C. § 1108 (Supp. III 1979). In order to do so, a reorganization trustee must be able to exercise the discretion a businessman would exercise in managing the affairs of the corporation, including the discretion to expend corporate assets for the bolstering of employee morale and in an attempt to eliminate substantial claims against the corporation.

(4th Cir. 1934). It has been acknowledged, for example, that "in a railroad reorganization, some payment on account of unfunded pension liabilities by the trustees are properly treated as necessary and usual operating expenses and as a cost of doing business." *In re Penn Central Transportation Co.*, 484 F. 2d 1300, 1304 (3d Cir. 1973), *cert. denied*, 415 U.S. 951 (1974). Additionally, continuing pension payments to retirees has been justified as necessary to maintain "the loyalty and incentive of present employees" and to facilitate the recruitment of new employees. *Tate* v. *New York, New Haven & Hartford Railroad*, 332 F. 2d 449, 452 (2d Cir. 1964). *See also Haberern* v. *Lehigh & New England Railway*, 554 F. 2d 581, 584 (3d Cir. 1977); *In re Regional Rail Reorganization Proceedings*, 421 F. Supp. 1061, 1071 (R.R.R. 1976) (Wisdom, J.). As the Fourth Circuit stated in *Bowen*:

> The superannuated employee, like the injured employee, has already made his contribution to the business; and no "economic benefit" results to the estate in receivership as the result of the payment of his pension except the intangible benefit of good will and strengthening of morale from honest dealing which results equally from the payment of disability compensation.
>
> * * * *
>
> Surely a court of equity, which has found means in receivership proceedings to protect the claim of the coal company which has furnished coal, the steel company which has furnished rails, and the workman who has furnished labor prior to the receivership, is not powerless to protect the rights of the injured or superannuated employee in the business which he has helped to build.

71 F. 2d at 785-86.

In summary, the decisions of the courts below unduly restrict the Trustee's powers and vitiate the careful design of ERISA. This important issue could not be more timely. As the nation's economy becomes a matter of grave concern, the number of businesses entering into bankruptcy proceedings is rapidly increasing.[18] The decision below places unnecessary constraints on the power of a reorganization trustee to rehabilitate a corporation and to satisfy his fiduciary obligations under ERISA.

2. The decision of the courts below is inconsistent with the rationale of this Court's decision in *Caplin* v. *Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972).

The lower court's ruling is premised on a misunderstanding of both the holding and rationale of this Court's decision in *Caplin*. That decision does not mandate the restrictive result reached below. Indeed, upon proper analysis, it supports the actions taken by the Trustee in the instant case.

First, contrary to the lower courts' apparent belief, the decision in *Caplin* simply did not address the authority of the Trustee to expend funds to preserve the vitality of a corporation in reorganization. Rather, *Caplin* concerned a purely procedural question—the standing of a trustee in reorganization to bring suit against an indenture trustee on behalf of persons holding the debtor's debentures. Indeed, this Court emphasized the narrow nature of the question before it:

> The sole issue in this case is whether petitioner, the trustee in reorganization . . . has standing under

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[18] A total of 3,975 reorganizations were filed in 1975. By contrast, during the 12-month period from October 1, 1979 to September 30, 1980, total filings numbered 5,745. Admin. Office of the U.S. Courts, Tables of Bankruptcy Statistics (1979); Admin. Office of the U.S. Courts, Annual Report of the Director (1979 & 1980 eds.).

> Chapter X of the Bankruptcy Act . . . to assert, on behalf of persons holding debentures issued by [the Debtor], claims of misconduct by an indenture trustee.

Caplin at 416.

The procedural question presented in *Caplin* is markedly different from the expenditure question involved in the instant case. Here, the Trustee has *not* asserted standing to file suit. Rather he has sought to expend corporate funds to improve employee morale, to minimize potential fiduciary claims against the Companies, and to fulfill the Companies' obligations under ERISA. *Caplin* obviously did not limit the substantial body of case law permitting a reorganization trustee to expend funds for purposes of this nature.

More importantly, *Caplin* was premised on the undisputed fact that the trustee there had no independent basis for standing apart from the Bankruptcy Act. Here, however, ERISA explicitly gives the Trustee, as a fiduciary, the right to sue on behalf of plan participants. Indeed, the co-fiduciary liability provisions of the statute require that the Trustee take remedial action. *Caplin* is wholly inapposite in these circumstances.

Finally, a key factor in the *Caplin* decision is absent in the instant case. In *Caplin*, the Court was concerned that a suit by the reorganization trustee "may be inconsistent with any independent actions that [the debenture holders] might bring themselves." *Caplin* at 431-32. The Court went on to point out that a class action brought by the debenture holders under Rule 23 would be not only a "powerful remedy," but also a preferable alternative to the trustee's action. *Caplin* at 433. Additionally, the Court noted that there had been no showing that permitting the trustee to sue on behalf of the debenture holders would reduce litigation. Indeed, there was

"every indication that litigation would be increased, or at least complicated" by the trustee's action. *Id.* at 434.

In sharp contrast, the Trustee in the instant case has not engaged in any litigation that would undermine the remedies available to the employee plaintiffs in *Fulk* v. *Bagley*. Rather, he has attempted to assist the plaintiffs in invoking the class action remedy which this Court viewed as most appropriate in *Caplin*. That class action, if permitted to proceed, undoubtedly will reduce and simplify the litigation generated by the mismanagement of the Companies' employee benefit plans. Nonetheless, the lower courts have jeopardized the continued existence of that action by preventing the Trustee from honoring his commitment to defray the litigation costs otherwise payable by the *Fulk* plaintiffs.

3. The lower courts' decision in this case conflicts with the Ninth Circuit's decision in *In re Equity Funding Corp. of America*, 519 F.2d 1274 (9th Cir. 1975).

Not only is the lower courts' interpretation of the Bankruptcy Act not compelled by the *Caplin* decision, it is inconsistent with the interpretation reached by several courts in the post-*Caplin* era. Those courts have found no barrier to the expenditure of corporate funds in aid of litigation, even where the trustee lacked standing to bring such litigation himself.

For example, in *In re Equity Funding Corp. of America*, 519 F.2d 1274 (9th Cir. 1975), the Ninth Circuit specifically approved such expenditures under facts remarkably similar to those at bar. In *Equity Funding*, the reorganization trustee of a bankrupt, diversified financial services company accepted the settlement of a collateral, state court liquidation proceeding involving an insurance company subsidiary of the bankrupt. As part of that settlement, a $2 million fund, made up substantially of assets of the subsidiary, was established to pay

the legal fees of certain parties in the state court proceeding and to defray the costs incurred by the plaintiffs in related fraud actions brought against the bankrupt. The district court approved the settlement, despite the opposition of other claimants who, like the respondents here, also were defendants in the related fraud litigation. On appeal, the Ninth Circuit upheld the trustee's actions, noting that the individuals objecting to the fund "oppose a settlement which places in the hands of the class lawyers . . . funds to finance the costs of the cases against themselves." *In re Equity Funding Corp. of America*, 519 F. 2d 1274, 1276 (9th Cir. 1975).[19]

The Ninth Circuit's decision to uphold the reorganization trustee's actions was based on its conclusion that the trustee had properly considered the relative economies of the options available to him and the potential risk to the value of the insurance business which might result from the delay involved in litigation. These are precisely the factors which led the Trustee in this case to follow a similar course of action. Like the trustee in *Equity Funding*, the Trustee here chose an economical and efficient route of protecting the estate by financing the costs incurred in the prosecution of the *Fulk* case.

The lower court's decision in this case also ignores the Fourth Circuit's own decision in *In re Farrington Manufacturing Co.*, 540 F.2d 653 (4th Cir. 1976). *Farrington* raised questions regarding the compensation of counsel for a Chapter X reorganization trustee. Of significance to this case, the district court in *Farrington*

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[19] The fact that respondents in this case are attempting to use their positions as shareholders in, or creditors of, the Companies to prevent the Trustee from financing the costs of a lawsuit in which they are defendants was not lost on the district court, since it noted that it could not "help but be aware that success on the issues now pending will redound to appellants' benefit in their capacities as defendants in the civil actions." App. B. at 8a.

refused to compensate the trustee's counsel for providing assistance to certain potential creditors of the estate who were suing third parties, much as the employees are now doing in the *Fulk* case. On appeal, the Fourth Circuit recognized that the trustee had no standing under *Caplin* to pursue such claims. Nonetheless, it found that "irrespective of whether [the trustee's] active participation as a party . . . may have been precluded by *Caplin*, [his activities] may have been of benefit to the debtor and its creditors." *Farrington* at 660. Finding "nothing improper" in those activities, the court authorized the trustee's counsel to be compensated from the estate for the assistance he rendered to the indenture holders. *Id.* Despite this clear support for the Trustee's actions in the instant case, neither of the courts below even mentioned *Farrington* in their decisions.

CONCLUSION

For all the reasons stated above, this Court should grant the petition for a writ of certiorari.

Respectfully submitted,

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APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 79-1644

DAVID R. JOHNSTON; THE NORTHWESTERN BANK; JAMES R. GILLEY,

Appellees,

versus

R. A. GILBERT, Trustee,

Appellant,

IN THE MATTER OF:

THE WASHINGTON GROUP, INC.;
CONVENIENT SYSTEMS, INC.;
WASHINGTON MILLS COMPANY;
JOHNSTON MILLS EXPORT COMPANY;
SPINNERS PROCESSING COMPANY;
WASHINGTON WEAVING COMPANY;
WASHINGTON MILLS SALES CORPORATION,

Debtors.

No. 79-1653

DAVID R. JOHNSTON; THE NORTHWESTERN BANK; JAMES R. GILLEY,

Appellees,

versus

GEORGE W. FULK, THOMAS W. SHELTON and WILLIAM F. SUDDETH,

Appellants,

IN THE MATTER OF:

THE WASHINGTON GROUP, INC.;
CONVENIENT SYSTEMS, INC.;
WASHINGTON MILLS COMPANY;
JOHNSTON MILLS EXPORT COMPANY;
SPINNERS PROCESSING COMPANY;
WASHINGTON WEAVING COMPANY and
WASHINGTON MILLS SALES CORPORATION,

Debtors.

No. 79-1654

DAVID R. JOHNSTON; THE NORTHWESTERN BANK; JAMES R. GILLEY,

Appellees,

versus

WEBSTER A. COLLINS, HERBERT R. MORRISON, HELEN O. MORRISON, W. O. GREGORY, and GLEN A. WILKINSON,

Appellants,

IN THE MATTER OF:

THE WASHINGTON GROUP, INC.;
CONVENIENT SYSTEMS, INC.;
WASHINGTON MILLS COMPANY;
JOHNSTON MILLS EXPORT COMPANY;
SPINNERS PROCESSING COMPANY;
WASHINGTON WEAVING COMPANY and
WASHINGTON MILLS SALES CORPORATION,

Debtors.

Appeal from the United States District Court for the Middle District of North Carolina, at Winston-Salem. Robert R. Merhige, Jr., District Judge

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Argued October 6, 1980 Decided November 4, 1980

Before HAYNSWORTH, Chief Judge, BUTZNER and SPROUSE, Circuit Judges

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O. William Faison; Calvin H. Cobb, Jr. and Howard H. Stahl (James D. Hutchinson, John D. Alkire, Peter L. Wellington, Steptoe & Johnson; C. Edwin Allman, R. Bradford Leggett, Hatfield & Allman; T. Winfield

Blackwell, Jr., Jack F. Canady, Jack E. Thornton, Jr., Blackwell, Blackwell, Canady & Eller; Henry A. Mitchell, Jr., Carl Patterson, Smith, Anderson, Blount, Dorsett, Mitchell and Jernigan on brief) for Appellants; W. Donald Carroll, Jr. (Jonathan E. Buchan, Helms, Mulliss & Johnston on brief); John H. Northey, III (Caudle, Underwood & Kinsey on brief); Roy G. Hall, Jr. (Hall and Liner on brief) for Appellees.

PER CURIAM:

The trustee in a Chapter X bankruptcy proceeding and past and present shareholders and employees of the debtor corporations appeal a district court judgment vacating two orders entered by the bankruptcy judge. These orders authorized the trustee to expend funds from the debtors' estate to defray the costs of two class action suits brought by employees, shareholders and, in one case, the trustee as a co-plaintiff against former officers, directors and fiduciaries of the debtors. The appellants primarily contend that the district court erred in holding that the trustee was not entitled to use funds in this manner. The parties also raise a number of threshold and procedural issues, including the correctness of the district court's ruling that the time to appeal the bankruptcy judge's orders should have been extended on grounds of excusable neglect.

We affirm for reasons sufficiently stated by the district judge in his opinion. *In re Washington Group, Inc.*, 476 F. Supp. 246 (M.D.N.C. 1979). We also find that those issues not governed by the opinion below do not compel a contrary result, and merit no further discussion.

Affirmed.

APPENDIX B

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF
NORTH CAROLINA
Winston-Salem Division

In Chapter X
Reorganization Numbers

B-77-695	B-77-696
B-77-697	B-77-698
B-77-699	B-77-700
B-77-701	B-77-702

[Filed Sept. 5, 1979]

IN THE MATTER OF:

THE WASHINGTON GROUP, INC.,
CONVENIENT SYSTEMS, INC.,
WASHINGTON MILLS COMPANY,
JOHNSTON MILLS COMPANY,
JOHNSTON MILLS EXPORT COMPANY,
SPINNERS PROCESSING COMPANY,
WASHINGTON WEAVING COMPANY and
WASHINGTON MILLS SALES CORPORATION,

Debtors.

MEMORANDUM

This matter is before the Court on appeal from an order of the Bankruptcy Court. The following two issues are presented: (1) whether in the circumstances of this case the Bankruptcy Judge erred in denying appellants an extension of time within which to file their appeal to this Court, and (2) whether the Bankruptcy Judge erred in allowing the Trustee in Bankruptcy to expend funds of the Debtors' estate to assist in defraying the costs of two potentially massive civil suits, in only one of which

the Trustee is a named plaintiff, against former officers, directors, and fiduciaries of the Debtors. The three appellants, David R. Johnston, James R. Gilley, and the Northwestern Bank, are creditors and shareholders of the bankrupt companies. Jurisdiction is proper under Bankruptcy Rule 801 and 28 U.S.C. § 1334.

On June 20, 1977, Chapter X reorganization proceedings commenced with respect to the Washington Group, Inc. and its subsidiaries. R. A. Gilbert was appointed Trustee in Bankruptcy, and he immediately began his investigation and operation of the bankrupt corporations. He filed his report to the Bankruptcy Court on June 30, 1978, and in that report he included facts pertaining to potential causes of action available to the estate.

On July 21, 1978 and July 25, 1978, respectively, the Bankruptcy Judge entered orders that (1) authorized the Trustee to assist employees of the Debtors in securing compensation for losses occasioned by mismanagement of employee benefit plans, and (2) authorized the Trustee to sue on behalf of the estate and to join with any other plaintiffs in such action. On July 25, 1978, two civil class actions suits relating to the affairs of the Debtors were filed in this court. *Gilbert* v. *Bagley*, C-78-335-WS, and *Fulk* v. *Bagley*, C-78-333-WS. *Gilbert* involves claims by the Trustee, on behalf of the Debtors, asserting waste, mismanagement, and breach of fiduciary duties by officers, directors, and other fiduciaries of the Debtors. Additionally, *Gilbert* includes claims by certain representative shareholders of the Debtor, The Washington Group, Inc., on behalf of a proposed class of such shareholders, based on alleged securities law fraud and related misconduct, as well as unlawful conduct during the pendency and settlement of an earlier shareholders' action. In *Fulk*, certain representative employees of the Debtors, on behalf of a proposed class of such employees, have asserted federal and common law claims arising

out of abuses in the management of the debtor corporations' various employee benefit plans by directors, officers, and other fiduciaries of the Debtors. The Trustee is not a party in *Fulk*. Discovery relative to class certification issues has been completed in both actions. General discovery, however, has been stayed pending resolution of a criminal action against certain of the named defendants.

On January 15, 1979, the Trustee filed an Application with the Bankruptcy Court seeking express authority to expend the funds of the Debtors for costs, other than attorneys' fees, in the *Gilbert* and *Fulk* actions, asserting that "it would be in the best interest of the continued administration of these reorganization proceedings to assist in defraying the reasonable and necessary costs of maintaining" the *Fulk* and *Gilbert* actions. No notice was given to the Debtors' creditors or stockholders. In an order dated January 16, 1979, without the benefit of any hearing, the Bankruptcy Judge granted the Application. That order stated in pertinent part:

> Upon the annexed Application of R. A. Gilbert, Trustee of the above-named Debtors, the Court having determined that said Application was one which might be heard *ex parte* and the Court having found as facts the matters stated in said Application; and for sufficient reasons appearing and good cause shown, it is
>
> ORDERED, ADJUDGED AND DECREED that the Trustee be and he is hereby authorized to use the funds of the Debtors to assist in defraying the reasonable and necessary costs of maintaining the two class actions known and designated as *Gilbert, et al.* v. *Bagley, et al.* and *Fulk, et al.* v. *Bagley, et al.*, which class actions are presently pending in the United States District Court for the Middle

District of North Carolina, save and except payment of professional fees of the attorneys for the class action plaintiffs.

The Clerk did not, nor was he directed to, send copies or other notice of this order to counsel for any of the creditors herein.

The ten day period within which to appeal this order expired on January 26, 1979. On February 9, 1979, David R. Johnston and the Northwestern Bank both filed Notices of Appeal from the January 16, 1979 order. On the same date, Johnston and Northwestern requested pursuant to Bankruptcy Rule 802(c) that the Bankruptcy Judge retroactively extend the ten-day period. On February 12, 1979, James R. Gilley filed his Notice of Appeal from the January 16, 1979 order, but did not request a retroactive extension of time. At a hearing on February 27, 1979, the Bankruptcy Judge denied the motions of Northwestern and Johnston for a retroactive extension of time in which to appeal. An order to that effect was entered on March 12, 1979. Northwestern filed a Notice of Appeal from the March 12, 1979 order on March 21, 1979, together with a Designation of Record on Appeal and Statement of Issues. On March 23, 1979 Johnston filed a Notice of Appeal of the March 12, 1979 order, together with his Designation of Record on Appeal and Statement of Issues.

On appeal before this Court, therefore, are the two orders of the Bankruptcy Judge entered on March 12, 1979 and January 16, 1979, respectively. Consideration of the earlier dated order is dependent upon a reversal of the later order.

Any analysis of these questions must be predicated upon an understanding of the overall context of and relationship between the bankruptcy proceedings and the pending civil actions. The three appellants in this

action, James R. Gilley, David R. Johnston, and the Northwestern Bank, are all defendants in *Gilbert*, and appellants Gilley and Northwestern are defendants in *Fulk*. Appellants Johnston and Northwestern, however, are also creditors of the bankrupt Debtors, and it is in this capacity that they are seeking to reverse the order of January 16, 1979 authorizing expenditure of the estate's funds to support the *Gilbert* and *Fulk* actions. Appellant Gilley is the majority shareholder of the Washington Group, and he is similarly interested in preventing improper use of the Debtor's limited resources. Therefore, while these appellants all may legitimately attack an order the effect of which will be dilution of the bankrupts' monies, the Court cannot help but be aware that success on the issues now pending will redound to appellants' benefit in their capacities as defendants in the civil actions.[1]

The threshold inquiry is whether the Bankruptcy Judge was mistaken in denying appellants' motion for a retroaction extension of the ten day appeal period. Bankruptcy Rule 802(c) requires that requests for extensions be made within the ten day period, "except that a request made after the expiration of such time may be granted upon a showing of excusable neglect." As the District Court for the Southern District of New York has noted:

> The question of excusable neglect is left to the discretion of the Bankruptcy Court Judge whose decision should not be set aside unless the 'reviewing

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[1] It is interesting to note that appellant Johnston apparently is a defendant in *Gilbert* because the Washington Group bought out his family's closely held textile company and he remained on as an employee. The complaint in *Gilbert* does not allege that Johnston was an officer or director of the Washington Group, but he admits to being a stockholder, leading the Court to wonder whether he ought not to be a plaintiff rather than a defendant. This question of course is not before the Court, and the Court expresses no opinion relative thereto.

> court has a definite and firm conviction that the court below committed a clear error of judgment . . . .'

In re Gurda, 19 Collier Bankruptcy Cases 568, 569 (S.D.N.Y. 1979) (footnote omitted). For the reasons that follow, the Court has concluded that the Bankruptcy Court's order of March 12, 1979 was clearly erroneous.

Notions of fundamental fairness impel a reviewing court to look closely at actions taken ex parte. This is especially so where a Trustee in Bankruptcy is asking for approval of what could be substantial expenditure of the Debtors' funds. Creditors and shareholders of the bankrupt estates have an absolutely legitimate interest in monitoring the manner in which the estate's resources are spent, and the Trustee, as their legal representative, owes them a duty to keep them informed of his activities. *See* Bankruptcy Rule 10-209. That the instant appellants also happen to be defendants in the *Bagley* and *Fulk* actions does not in any way limit their right, as creditors and shareholders, to be informed of, and in appropriate circumstances, to participate in, important actions taken by the Trustee. The Court therefore cannot help but look initially with suspicion upon the actions taken in this matter by both the Trustee and the Bankruptcy Court.

Appellants have not cited, nor has the Court in its research discovered, either a case or Bankruptcy Rule precisely on point. Other than the broad principles enunciated above, drawn from the general spirit of the bankruptcy process, Bankruptcy Rule 10-209(b)(6) seems to be the most nearly applicable provision. It provides that the Trustees shall give all creditors and stockholders at least twenty days notice of "the hearing on applications for . . . reimbursements of expenses." *See also* Rule 10-216. Here, of course, the Trustee was not seeking reimbursement of expenses; rather, he was asking for a blank check with which to draw an undetermined, but

clearly substantial, amount from the funds of the Debtors. The Court cannot imagine a clearer instance, not explicitly covered by the Rules, in which notice to creditors and shareholders would be appropriate.

Rule 922(a) requires the Bankruptcy Court to mail notice of orders entered to any party who opposed the entry of the order. No such notice was mailed with regard to the January 16 order. The Trustee argues, however, that notice was not required because no one opposed his application. Though this may be technically correct, the Court will not penalize appellants for their failure to oppose an application submitted without notice to them and decided without giving them an opportunity to be heard.

The Trustee also argues that the January 16 order merely confirmed the authority already granted him by the Bankruptcy Court in its orders of July 11 and 25, 1978, and that, because appellants did not appeal those orders, they should not now be allowed to appeal the January 16 order. Suffice it to say that, had the July orders actually granted the Trustee the authority to use the Debtors' funds to help support the *Gilbert* and *Fulk* actions, the Court is at a loss to understand why the Trustee felt it incumbent to make further application to the Bankruptcy Court.

Appellants and the Trustee agree that appellants did not learn of the January 16 order until January 31. They further agree that appellants Johnston and Northwestern filed their notices of appeal nine days later. The tenth day, February 10, was a Saturday, and appellant Gilley filed his notice of appeal on Monday, February 12. This delay, with the attendant circumstances already discussed, quite clearly falls within the "excusable neglect" exception to the Rule 802(a) requirement that notices of appeal be filed within ten days. As the United States Court of Appeals for the Fourth Circuit has noted

in a related context: "Failure to learn of the entry of judgment is the principal ground on which extensions of time for appeal are granted." *Babich* v. *Clower*, 528 F.2d 293, 295 (4th Cir. 1975). Accordingly, the March 12, 1979 order of the Bankruptcy Court denying appellants Johnston's and Northwestern's motions for extensions of time within which to appeal the order of January 16, 1979 will be vacated, and the Bankruptcy Court will be directed to grant the motions. Because the Bankruptcy Court should have allowed appellants to file notices of appeal regarding the order of January 16, the Court will now consider the appropriateness of that order.

As a general proposition, it is beyond dispute that the Trustee's duty is to act in the best interests of the Debtors' estate. Protection of the rights and interests of creditors and shareholders, with which the Trustee is charged, depends largely upon the success of the Trustee in managing the estate, and his actions must be calculated to bring *direct* benefit to the estate. There is of course no question regarding the Trustee's authority to sue on behalf of the estate. Expenditure of the estate's funds in this regard is entirely proper, for success by the Trustee in *Gilbert* will accrue directly to the benefit of the estate. Of concern to appellants, however, is use of the estate's resources to help prosecute actions by the shareholder plaintiffs in *Gilbert* and all the plaintiffs in *Fulk*. Should these plaintiffs prevail, not one dime of their recovery will go into the treasury of the Debtors' estate.

The Trustee asserts that expenditure of the estate's funds to help support the *Gilbert* action may be justified on three grounds:

> (a) recovery by plaintiff stockholders in *Gilbert* would eliminate claims which might otherwise be made in the reorganization proceeding . . . ; (b) the close interrelationship of the claims of the

> Trustee . . . and the shareholder plaintiffs . . . clearly indicates that a strong and vigorous prosecution of the shareholders' claims through discovery and into trial would prove to be a material benefit to the discovery and proof of evidence to support the Trustee's claims; [and] (c) proof of matters which support the basis for the claims of the plaintiff shareholders against the defendants, insofar as these claims are distinct from the Trustee's action, could . . . expedite and facilitate the objection to claims which have been filed by certain of the defendants in the reorganization proceedings.

With respect to *Fulk*, the Trustee argues that "[p]ension-related claims are entitled to special consideration in a reorganization proceeding and may even be entitled to treatment as a first priority administrative expense." He further notes that the Trustee is charged with attempting to continue operation of the Debtors' estate, and that this duty cannot be fulfilled without boosting and maintaining the morale of the employees—a task made much easier if compensation owed from employee benefit plans is paid to the employees.

Notwithstanding the apparent logic of the Trustee's arguments, his authority is strictly prescribed by the Bankruptcy Act. Congress might well have decided to grant the Trustee broad license either to sue on behalf of or provide financial assistance to third parties with claims against the estate. The Court has concluded, however, that the Bankruptcy Act contemplates a narrower range of options for the Trustee. He may only bring actions and expend funds on behalf of the estate. If he is successful, his duty is then to apportion, in accordance with the provisions of the Act, whatever recovery he reaps among the various parties with claims against the estate. Claimants of course include creditors, shareholders, and in this case employees. The high priority afforded pension-related claims does not mean the Trustee

may expend funds of the estate to support a class action suit by employees, as meritorious as it may appear. It means instead that, when the time comes to attempt to satisfy the obligations of the Debtors, employees thereof are entitled to stand near the front of the line. That shareholders and employees will no doubt have claims against the estate does not justify the Trustee's reaching into the estate's coffers to help them sue former officers, directors, and fiduciaries of the estate. The shareholders and employees' causes of action against these defendants are independent from whatever claims they may also wish to pursue against the estate.

The leading case in this area, cited and relied upon by both the Trustee and the appellants, is *Caplin* v. *Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972). As the Trustee notes in his brief, *Caplin* is a decision regarding a "Trustee's standing to sue, not . . . the appropriateness of litigation-related expenditures which may benefit the estate." That the Supreme Court did not have occasion to address this latter issue does not prevent this Court from applying to the instant case the principles on which *Caplin* rests.

Caplin involved a suit brought by a Chapter X Trustee, on behalf of those persons owning debentures issued by the bankrupt company, against the indenture trustee for breach of its duty owed to the debenture holders. The Trustee in *Caplin* argued, among other things, that it was in a "better position than debt investors to discover and to prosecute claims based on the alleged failure of an indenture trustee to live up to the provision of the indenture." *Id.* at 427. The Court disagreed, noting that "Congress has established an elaborate system of controls with respect to indenture trustees and reorganization proceedings, and nowhere in the statutory scheme is there any suggestion that the trustee in reorganization is to assume the responsibility of suing third parties on behalf of debenture holders." *Id.* at 428. Then, in a

passage critical to the instant case, the Court referred to 11 U.S.C. § 567(3), which is the pivotal provision of the Bankruptcy Act prescribing the powers and duties of the Trustee, and asserted that "there is nothing in the section that enables [the Trustee] to collect money not owed to the estate." *Id.* The rationale of the Court's holding in *Caplin* is unmistakable. The Trustee may only act for the direct benefit of the estate. In asking this Court to limit *Caplin* to cases where the Trustee actually is suing on behalf of some third party claimant, as opposed to cases where the Trustee is merely footing the bill, the Trustee is requesting the Court to allow him to do indirectly what *Caplin* forbids his doing directly.[2]

For the foregoing reasons, the Court has concluded that the Bankruptcy Court's order of January 16, 1979 must be vacated, and the Trustee's application of January 15, 1979 must be denied to the extent it sought authority to use the funds of the estate to help support claims other than that brought by the Trustee.

An appropriate order shall issue.

/s/ Robert R. Merhige
United States District Judge

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[2] At least two other courts have applied this rationale. In *Rochelle* v. *Marine Midland Grace Trust Co.*, 535 F.2d 523, 527 (9th Cir. 1976), Judge Hufstedler cited *Caplin* in summarily affirming the district court's dismissal of a suit brought by the Trustee on behalf of the Debtor's creditors and debenture purchasers: "[A] reorganization trustee has no standing to maintain the action on the part of any person or entity other than his debtor corporation." Similarly, in *King* v. *Sharp*, 63 F.R.D. 60, 63 (N.D. Tex. 1974), the Court noted that: "Congress has not seen fit to endow a Chapter X Trustee with the freedom to champion causes that will produce benefits to third parties. If the bankrupt estate has no cause of action in its own right, then the Trustee has no authority to institute suits as a class representative or otherwise for the benefit of third parties."

APPENDIX C

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF
NORTH CAROLINA
Winston-Salem Division

In Chapter X
Reorganization Numbers

B-77-695	B-77-696
B-77-697	B-77-698
B-77-699	B-77-700
B-77-701	B-77-702

[Filed Sept. 5, 1979]

IN THE MATTER OF:

THE WASHINGTON GROUP, INC.,
CONVENIENT SYSTEMS, INC.,
WASHINGTON MILLS COMPANY,
JOHNSTON MILLS COMPANY,
JOHNSTON MILLS EXPORT COMPANY,
SPINNERS PROCESSING COMPANY,
WASHINGTON WEAVING COMPANY and
WASHINGTON MILLS SALES CORPORATION,
Debtors.

ORDER

For the reasons stated in the memorandum of the Court this day filed, and deeming it proper so to do, it is ADJUDGED and ORDERED as follows:

1. The orders of the Bankruptcy Court dated March 12, 1979 and January 16, 1979 are hereby vacated; and

2. The Bankruptcy Court is directed (a) to enter an order granting appellants' request for a retroactive extension of time within which to file their Notices of

Appeal, and (b) to enter an order denying the Trustee's application of January 15, 1979 requesting authority to utilize funds of the Debtors to defray the costs of prosecuting *Gilbert, et al.* v. *Bagley, et al.*, No. C-78-335-WS, and *Fulk, et al.* v. *Bagley, et al.*, No. C-78-333-WS, except that the Trustee may utilize the Debtor's fund to prosecute that portion of the *Gilbert* action in which the Trustee is suing on behalf of the Debtors' estate:

Let the Clerk send copies of the memorandum and this order to all counsel of record.

/s/ Robert Merhige
ROBERT MERHIGE
United States District Judge

APPENDIX D

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF
NORTH CAROLINA

In Chapter X
Reorganization Numbers

B-77-695, B-77-696,
B-77-697, B-77-698,
B-77-699, B-77-700,
B-77-701, and B-77-702

[Filed July 20, 1978]

IN THE MATTER OF:

THE WASHINGTON GROUP, INC.,
CONVENIENT SYSTEMS, INC.,
WASHINGTON MILLS COMPANY,
JOHNSTON MILLS COMPANY,
JOHNSTON MILLS EXPORT COMPANY,
SPINNERS PROCESSING COMPANY,
WASHINGTON WEAVING COMPANY and
WASHINGTON MILLS SALES CORPORATION,
Debtors.

ORDER GRANTING AUTHORITY TO AID AND ASSIST IN THE PROSECUTION OF LEGAL ACTION BASED ON CLAIMS ARISING OUT OF THE ADMINISTRATION OF THE DEBTORS' PROFIT SHARING PLANS

At Greensboro, in said district, on the 21 day of July, 1978.

Upon the annexed application of the Trustee for the above-named Debtors, and the Court having found the

facts to be as stated therein, and for good cause shown; it is

ORDERED that R.A. Gilbert, Trustee, is granted permission and authority to take whatever action is deemed appropriate to assert a claim or cause of action for or on behalf of the employees of the Debtors who were adversely affected by the mismanagement of the Profit Sharing Plans established by Washington Mills Company and Johnston Mills Company, or, in the alternative, he is authorized to assist the affected employees in securing compensation for their losses arising on account of such mismanagement.

/s/ Rufus W. Reynolds
RUFUS W. REYNOLDS
Bankruptcy Judge

APPENDIX E

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF
NORTH CAROLINA

In Chapter X
Reorganization Numbers

B-77-695, B-77-696,
B-77-697, B-77-698,
B-77-699, B-77-700,
B-77-701, and B-77-702

[Filed Jan. 15, 1979]

IN THE MATTER OF:

THE WASHINGTON GROUP, INC.,
CONVENIENT SYSTEMS, INC.,
WASHINGTON MILLS COMPANY,
JOHNSTON MILLS COMPANY,
JOHNSTON MILLS EXPORT COMPANY,
SPINNERS PROCESSING COMPANY,
WASHINGTON WEAVING COMPANY, and
WASHINGTON MILLS SALES CORPORATION,
Debtors.

ORDER AUTHORIZING EXPENDITURE OF FUNDS FOR COSTS IN PLENARY CLASS ACTIONS

At Greensboro, N.C., in said District, this 16th day of January, 1979.

Upon the annexed Application of R. A. Gilbert, Trustee of the above named Debtors, the Court having determined that said Application was one which might be heard *ex parte* and the Court having found as facts the matters stated in said Application; and for sufficient reasons appearing and good cause shown, it is

ORDERED, ADJUDGED AND DECREED, that the Trustee be and he is hereby authorized to use the funds of the Debtors to assist in defraying the reasonable and necessary costs of maintaining the two class actions known and designated as *Gilbert, et al.* v. *Bagley, et al.* and *Fulk, et al.* v. *Bagley, et al.*, which class actions are presently pending in the United States District Court for the Middle District of North Carolina, save and except payment of professional fees of the attorneys for the class action plaintiffs.

/s/ Rufus W. Reynolds
RUFUS W. REYNOLDS
Bankruptcy Judge

APPENDIX F

IN THE UNITED STATES DISTRICT COURT FOR THE MIDDLE DISTRICT OF NORTH CAROLINA

In Chapter X
Reorganization Numbers

B-77-695, B-77-696,
B-77-697, B-77-698,
B-77-699, B-77-700,
B-77-701, and B-77-702
[Filed Mar. 12, 1979]

IN THE MATTER OF:

THE WASHINGTON GROUP, INC.,
CONVENIENT SYSTEMS, INC.,
WASHINGTON MILLS COMPANY,
JOHNSTON MILLS COMPANY,
JOHNSTON MILLS EXPORT COMPANY,
SPINNERS PROCESSING COMPANY,
WASHINGTON WEAVING COMPANY and
WASHINGTON MILLS SALES CORPORATION,
Debtors.

ORDER DENYING MOTIONS FOR EXTENSION OF TIME IN WHICH TO FILE NOTICE OF APPEAL

At Greensboro, in said district, on the 12th day of March, 1979.

This matter coming on for hearing and being heard on the motions of The Northwestern Bank and David R. Johnston seeking an extension of time in which to file notice of appeal of an order entered by this Court on January 16, 1979, and the Court finding that said motions were not filed within ten days following the date of entry of said order; and the Court having concluded that it does not have authority under the provisions of

Rule 802(c) and Rule 10-801, Rules of Bankruptcy Procedure, to extend the time for filing notice of appeal once the initial ten-day period has expired; and the Court further concluding that if it did have such authority, in the exercise of its discretion it would deny the motions for extension of time in which to file notice of appeal; it is

ORDERED that the motions filed on behalf of The Northwestern Bank and David R. Johnston on February 9, 1979 seeking an extension of time for filing their notices of appeal be, and the same hereby are, denied, and since this Court has concluded it is without authority to act, such denial is without prejudice to The Northwestern Bank and David R. Johnston to renew and present those same motions to the United States District Judge.

/s/ Rufus W. Reynolds
RUFUS W. REYNOLDS
Bankruptcy Judge

APPENDIX G

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

[Filed July 10, 1980]

No. 79-1644

DAVID R. JOHNSTON; THE NORTHWESTERN BANK; *et al.*,
Appellees

v.

R. A. GILBERT, Trustee,
Appellant

No. 79-1653

DAVID R. JOHNSTON; THE NORTHWESTERN BANK; *et al.*,
Appellees

v.

GEORGE W. FULK, *et al.*,
Appellants

No. 79-1654

DAVID R. JOHNSTON; THE NORTHWESTERN BANK; *et al.*,
Appellees

v.

WEBSTER A. COLLINS, *et al.*,
Appellants

ORDER

On September 5, 1979 the district court reversed a January 16, 1979 order of the bankruptcy court authorizing the expenditure of funds and costs in two class actions, the short styles of which are *Gilbert* v. *Bagley*, No. C-78-335-WS (M.D. N.C.), and *Fulk* v. *Bagley*, No. C-78-333-WS (MD NC). The expenditure of funds and

costs was to be used by the trustee to aid and assist in the prosecution of said civil suits on behalf of the bankrupt estate, which had been authorized by order dated July 21, 1978.

Later, by opinion dated May 15, 1980, the bankruptcy court, in an opinion in another but related matter, indicated that its initial authority to proceed with the *Gilbert* and *Fulk* civil actions in the Middle District of North Carolina, and the expenditure of funds for that purpose, had been a mistake. Nevertheless, orders of the bankruptcy court, above mentioned, of July 21, 1978 and January 15, 1979, are yet extant, and, so far as we are advised, are unmodified except by the order of the district court of September 5, 1979, above mentioned, which is the order appealed from.

No reason has been brought to our attention why the orders of the bankruptcy court authorizing the trustee to proceed with the *Gilbert* and *Fulk* cases, and authorizing the expenditure of funds on that account, could not be later revoked by the bankruptcy court. If that were done, the instant appeal might well be moot. But the orders of the bankruptcy court of July 21, 1978 and January 16, 1979 are yet in full force and virtue but for the order of the district court appealed from.

We are thus of opinion the case is not now moot, and it is accordingly ADJUDGED and ORDERED that the motion to dismiss the appeal on account of mootness shall be, and the same hereby is, denied.

With the concurrences of Judge Haynsworth and Judge Hall.

/s/ H. Emory Widener
H. EMORY WIDENER
For the Court

APPENDIX H

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

November 04, 1980

To:

Henry C. Ikenberry, Esq.
James D. Hutchinson, Esq.
Howard H. Stahl, Esq.
Laura Stone, Esq.
Charles G. Cole, Esq.

T. Winfield Blackwell, Esq.
Jack F. Canady, Esq.

Roy G. Hall, Esq.

W. Donald Carroll, Esq.

John H. Northey, Esq.
Lloyd Caudle, Esq.

NOTICE OF JUDGMENT

Judgment was entered in Case No. 79-1653 this date. The Court's opinion is enclosed.

Petition for Rehearing (FRAP 40)

Filing Time

A petition may be filed within 14 days after judgment. *No extensions will be granted save for the most compelling reasons.* Requests based on grounds such as miscalculation of time or a need to consult with others will be peremptorily denied.

Purpose

A petition should only be made to direct the Court's attention to one or more of the following situations:

1. A material fact or law overlooked in the decision.
2. A change in the law which occurred after the case was submitted and which was overlooked by the panel.

3. An apparent conflict of another decision of the Court which is not addressed in the opinion.

The filing of a petition in order merely to reargue the case is an abuse of the privilege.

Statement of Counsel

A petition shall contain an introductory statement that, in counsel's judgment, one or more of the situations exists which is described in the "Purpose Section" discussed above. Thereafter, the points to be raised, succinctly stated, shall then be listed in the statement. Lacking such a statement, the petition will be returned to counsel without filing.

Form

The 15 page limit allowed by the Rule shall be observed. The Court requires 15 copies of the petition; however, a pro se party who is indigent may file the original only.

Bills of Costs (FRAP 39)

Filing Time

A party to whom costs are allowed, who desires taxation of costs, shall file a bill of costs within 14 days after judgment.

Mandate (FRAP 41)

Issuance Time

The mandate is issued 21 days after judgment. A timely petition for rehearing will stay the issuance. If the petition is denied, the mandate will issue 7 days later. If a stay of mandate is sought, only the original of a motion need be filed.

WILLIAM K. SLATE, II
CLERK

Enclosure
4CCA 28
Rev. 9/17/79

APPENDIX I

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Nos. 79-1644, 79-1653, 79-1654

[Filed Jan. 19, 1981]

DAVID R. JOHNSTON, THE NORTHWESTERN BANK, JAMES R. GILLEY,

Appellees,

vs.

R. A. GILBERT, Trustee, GEORGE W. FULK, THOMAS W. SHELTON, WILLIAM F. SUDDETH, WEBSTER A. COLLINS, HERBERT R. MORRISON, HELEN O. MORRISON, W. O. GREGORY and GLEN A. WILKINSON,

Appellants

IN THE MATTER OF:

THE WASHINGTON GROUP, INC.,
CONVENIENT SYSTEMS, INC.,
WASHINGTON MILLS COMPANY,
JOHNSTON MILLS EXPORT COMPANY,
SPINNERS PROCESSING CO.,
WASHINGTON WEAVING CO., and
WASHINGTON MILLS SALES CORP.,

Debtors.

ORDER

Upon consideration of the petition for rehearing, no request for a poll of the court being made on the suggestion for rehearing *en banc*, and with the concurrence of Judge Butzner and Judge Sprouse,

IT IS ORDERED that the petition be, and it is hereby, denied.

FOR THE COURT:
/s/ Clement F. Haynsworth
CLEMENT F. HAYNSWORTH
Chief Judge, Fourth Circuit

January 14, 1981

APPENDIX J

ERISA § 3(21), 29 U.S.C. § 1002(21), provides:

(21)(A) Except as otherwise provided in subparagraph (B), a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section 405(c)(1)(B).

(B) If any money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940, such investment shall not by itself cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest as those terms are defined in this title, except insofar as such investment company or its investment adviser or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter. Nothing contained in this subparagraph shall limit the duties imposed on such investment company, investment adviser, or principal underwriter by any other law.

* * * *

ERISA § 405, 29 U.S.C. § 1105, provides:

SEC. 405. (a) In addition to any liability which he may have under any other provision of this part, a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan in the following circumstances:

(1) if he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach;

(2) if, by his failure to comply with section 404 (a) (1) in the administration of his specific responsibilities which give rise to his status as a fiduciary, he has enabled such other fiduciary to commit a breach; or

(3) if he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

(b) (1) Except as otherwise provided in subsection (d) and in section 403(a) (1) and (2), if the assets of a plan are held by two or more trustees—

(A) each shall use reasonable care to prevent a co-trustee from committing a breach; and

(B) they shall jointly manage and control the assets of the plan, except that nothing in this subparagraph (B) shall preclude any agreement, authorized by the trust instrument, allocating specific responsibilities, obligations, or duties among trustees, in which event a trustee to whom certain responsibilities, obligations, or duties have not been allocated shall not be liable by reason of this subparagraph (B) either individually or as a trustee for any loss resulting to the plan arising from the acts or omissions on the part of another trustee to whom such responsibilities, obligations, or duties have been allocated.

(2) Nothing in this subsection shall limit any liability that a fiduciary may have under subsection (a) or any other provision of this part.

(3) (A) In the case of a plan the assets of which are held in more than one trust, a trustee shall not be liable

under paragraph (1) except with respect to an act or omission of a trustee of a trust of which he is a trustee.

(B) No trustee shall be liable under this subsection for following instructions referred to in section 403 (a) (1).

(c) (1) The instrument under which a plan is maintained may expressly provide for procedures (A) for allocating fiduciary responsibilities (other than trustee responsibilities) among named fiduciaries, and (B) for named fiduciaries to designate persons other than named fiduciaries to carry out fiduciary responsibilities (other than trustee responsibilities) under the plan.

(2) If a plan expressly provides for a procedure described in paragraph (1), and pursuant to such procedure any fiduciary responsibility of a named fiduciary is allocated to any person, or a person is designated to carry out any such responsibility, then such named fiduciary shall not be liable for an act or omission of such person in carrying out such responsibility except to the extent that—

(A) the named fiduciary violated section 404(a)(1)—

(i) with respect to such allocation or designation,

(ii) with respect to the establishment or implementation of the procedure under paragraph (1), or

(iii) in continuing the allocation or designation; or

(B) the named fiduciary would otherwise be liable in accordance with subsection (a).

(3) For purposes of this subsection, the term "trustee responsibility" means any responsibility provided in the plan's trust instrument (if any) to manage or control

the assets of the plan, other than a power under the trust instrument of a named fiduciary to appoint an investment manager in accordance with section 402(c)(3).

(d)(1) If an investment manager or managers have been appointed under section 402(c)(3), then, notwithstanding subsection (a)(2) and (3) and subsection (b), no trustee shall be liable for the acts or omissions of such investment manager or managers, or be under an obligation to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager.

(2) Nothing in this subsection shall relieve any trustee of any liability under this part for any act of such trustee.

* * * *

11 U.S.C. § 1108 (Supp. III 1979) provides:

§ 1108. Authorization to operate business

Unless the court orders otherwise, the trustee may operate the debtor's business.

Pub. L. 95-598, Nov. 6, 1978, 92 Stat. 2629.

* * * *

Rule 10-208 of the Federal Rules of Bankruptcy Procedure provides:

Rule 10-208. Duty of Trustee and Debtor in Possession to Investigate, Make Reports, Furnish Information, and Prepare Plans; Examiners

(a) **Trustee.** A trustee shall (1) file the lists as required by Rule 10-108; (2) unless otherwise ordered, make a report at the meeting provided for in Rule 10-212 which shall include a summary of his operations of the business and management of the property; (3) file with the court within the times fixed by the court, periodic reports and summaries of the operations of the business and such other information as may be required by the court; (4) investigate the acts, conduct, liabilities

and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the case or to the formulation of a plan; (5) file a report with the court concerning any facts ascertained by him pertaining to fraud, misconduct, mismanagement, and irregularities, and to any causes of action available to the estate; (6) if the court so authorizes, examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters; (7) as soon as practicable, file a statement of his investigations, and cause copies or a summary thereof to be mailed to the creditors, stockholders, indenture trustees, the Securities and Exchange Commission, and such other persons as the court may designate; (8) notify creditors and stockholders that they may submit to him plans or suggestions for the formulation of a plan, within a time fixed by him in such notice; (9) file a plan or report as required by Rule 10-301(c)(1); (10) within 30 days after the date of the order confirming the plan or within such other time as the court may fix, file a report with the court concerning the action taken by him and the progress made in the consummation of the plan and file such further reports as the court may direct until the plan has been consummated; and (11) after consummation of a plan, file an application for a final decree showing that the plan has been consummated, and the names and addresses, if known, of the holders of claims or interests which have not been surrendered or released in accordance with the provisions of the plan and the nature and amounts of such claims or interests, and such other facts as may be necessary to enable the court to pass upon the provisions to be included in the final decree.

(b) **Debtor in Possession; Examiner.** If a debtor is continued in possession it shall perform the duties specified in subdivision (a)(9) and such other duties specified in subdivision (a) of this rule as directed by the

court or the court may appoint a disinterested person as specified in Rule 10-202(c) as examiner to perform all or any of such duties.

(c) **Transmission of Reports; Form.** The court shall direct copies or summaries of annual reports, and may direct copies or summaries of other reports, to be mailed to the creditors, stockholders, and indenture trustees, and may also direct the publication of summaries of any such reports. The Securities and Exchange Commission may recommend the form of such reports and summaries.

APPENDIX K

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF
NORTH CAROLINA

In Chapter X
Reorganization Numbers
B-77-695, B-77-696,
B-77-697, B-77-698,
B-77-699, B-77-700,
B-77-701, and B-77-702

[Filed June 30, 1978]

IN THE MATTER OF:

THE WASHINGTON GROUP, INC.;
CONVENIENT SYSTEMS, INC.;
WASHINGTON MILLS COMPANY;
JOHNSTON MILLS COMPANY;
JOHNSTON MILLS EXPORT COMPANY;
SPINNERS PROCESSING COMPANY;
WASHINGTON WEAVING COMPANY;
WASHINGTON MILLS SALES CORPORATION;
Debtors

REPORT OF TRUSTEE'S INVESTIGATION
PURSUANT TO RULE 10-208(a)

/s/ R. A. Gilbert
R. A. GILBERT, Trustee
Post Office Box 1015
Winston-Salem, NC 27102
Telephone: (919) 765-9540

/s/ C. Edwin Allman
C. EDWIN ALLMAN
Attorney for the Trustee

OF COUNSEL:
Hatfield and Allman
Post Office Drawer 593
Winston-Salem, NC 27102
Telephone: (919) 722-2300

* * * *

H. EMPLOYEES' PROFIT-SHARING PLANS

In the course of investigating the debtors' affairs, counsel for the Trustee became aware of the manner and the method in which American Bank and Trust Co. of Pa., Reading, Pennsylvania, (hereinafter referred to as "American Bank"), dealt with the assets of various profit-sharing plans of certain of the debtors.

Prior to August 29, 1974, Wachovia Bank and Trust Company, N.A., Winston-Salem, North Carolina (hereinafter referred to as "Wachovia"), was the trustee for profit-sharing plans of Washington Mills Company, and North Carolina National Bank, Charlotte, North Carolina (hereinafter referred to as "NCNB"), was the trustee for profit-sharing plans of Johnston Mills Company and its affiliates. On August 29, 1974, American Bank was named trustee, as successor to Wachovia and NCNB, respectively, for all of the profit-sharing plans referred to above. American Bank remained trustee for only one year, whereupon The Northwestern Bank, North Wilkesboro, North Carolina, was named trustee, as successor to American Bank. During the year that American Bank was trustee, however, it took certain actions in its fiduciary capacity, apparently in violation of its fiduciary obligations. Specifically, it appears that immediately after American Bank became trustee, it sold substantial holdings of blue-chip stocks and bonds in one day. The proceeds of such sales were used to purchase shares of the common stock of The Washington Group, Inc. at peak prices on the over-the-counter market. A careful analysis of the financial statements of The Washington Group, Inc., tends to indicate that the act of American Bank in funding the corpuses of the several profit-sharing plans so heavily with The Washington Group, Inc. stock was unjustifiable.

On October 2, 1974, American Bank sold certain large blocks of blue-chip stocks and bonds (for example, Xerox Corp.; CBS, Inc.; DuPont; General Electric; and IBM) that it had received from Wachovia, as its predecessor trustee. These stocks were sold for a total of $446,343, at a loss of $488,611. American Bank then began to purchase shares of the common stock of The Washington Group, Inc. to fund the profit-sharing plans.

Beginning about the middle of October 1974, and continuing through November 6, 1974, American Bank purchased for Washington Mills Company's two profit-sharing plans, 13,800 shares of stock in The Washington Group, Inc. at an average cost of $19.20 per share and a total cost of $264,913. These purchases, plus 6,000 shares received from the predecessor trustee, resulted in an investment in 19,800 shares of The Washington Group, Inc. stock, at a total cost of $364,413. At that time, more than 40% of the total assets of the profit-sharing plans of Washington Mills Company were made up of the common stock of The Washington Group, Inc.

There was similar purchasing activity during the same period in the common stock of The Washington Group, Inc., by American Bank, as trustee, in all of the other profit-sharing plans of the debtors. These plans reflected similarly egregious results as to the ratio of the value of the said debtor's common stock to all other plan assets.

The participants in the various profit-sharing plans were the losers as a result of American Bank's activities in selling the blue-chip stocks and bonds in question and in purchasing The Washington Group, Inc., stock. Not only were blue-chip securities paying reasonable dividends and interest, but also, as a prudent man should have known, they held far greater promise of appreciation. Had the blue-chip securities been held until June

1978, by way of illustration, their fair market value would have been approximately $777,500, plus dividends paid of approximately $87,000. When American Bank purchased the shares in The Washington Group, Inc., only a small dividend per share was being paid, and the company had heavy indebtedness.

As of September 30, 1974, the profit-sharing plans for all debtors having such plans were discontinued but the assets were not distributed to the participants. This meant that no further contributions would be made to the trusts and that the trustee, as fiduciary, had the concomitant duties to preserve and to make productive the assets in the various trusts. Again, the participants in the profit-sharing plans were the losers.

A careful review of corporate correspondence, together with conversations with past and present corporate employees, compels the inferences that American Bank's actions in selling the blue-chip stocks and bonds and in purchasing The Washington Group, Inc. stock were encouraged in great measure by management of The Washington Group, Inc., and that, as a condition to its appointment as trustee, American Bank agreed to invest a large percentage of the trusts' assets in the stock of The Washington Group, Inc. Such actions were to the substantial detriment of approximately 2,500 participating employees of the debtor companies. Many of these participants are still employed by the debtors. All evidence indicates that American Bank was most imprudent in its investment procedures in this connection.

In summary, this conduct on the part of the bank and the debtors' management appears to have been the single most callous act revealed by the Trustee during the course of the Rule 10-208(a) examination. Therefore, the Trustee, without any reservation whatsoever, respectfully recommends to the Court that he be authorized and

permitted to take whatever action is deemed appropriate to assert a claim or cause of action for and on behalf of the employees of the debtors who were adversely affected by the mismanagement of the profit-sharing plans, or, in the alternative, that he be authorized to assist the affected employees in securing compensation for their losses. Poor morale has been a sizable problem since the debtors filed for corporate reorganization, and it is the opinion of the Trustee that, if the Court would authorize him to expend funds of the debtors to assist in the prosecution of actions against American Bank and such other proper parties for the recovery of losses resulting from these mismanaged profit-sharing plans, the morale of the debtors' employees would be vitally improved.

* * * *

APPENDIX L

IN THE UNITED STATES DISTRICT COURT
FOR THE MIDDLE DISTRICT OF
NORTH CAROLINA
Winston-Salem Division

Civil Action No. 78-333-WS

[Filed Sept. 2, 1980]

GEORGE W. FULK, CHAIRMAN OF THE PENSION, PROFIT-SHARING, AND STOCK PURCHASE PLAN COMMITTEES OF THE WASHINGTON GROUP, INC.,

—and—

RUBY IRENE LESTER, *et al.*,
Plaintiffs,

v.

SMITH W. BAGLEY, *et al.*,
Defendants.

MEMORANDUM

The First Amended Complaint ("the complaint") in this cause seeks an accounting and compensatory relief from each defendant by virtue of the allegations in the complaint's three counts. Count I arises under The Employee Retirement Income Security Act of 1974 ("ERISA" or "the Act"), 29 U.S.C. § 1001 *et seq.* The second count is brought pursuant to the anti-fraud provision of The Securities Exchange Act of 1934, 15 U.S.C. § 78(a) *et seq.* Count III is a claim for breach of fiduciary duty which arises under the common law of the State of North Carolina.

Several motions are presently pending before the Court. Each defendant has moved to dismiss the com-

plaint or, in the alternative, to strike portions thereof.[1] Also pending is plaintiffs' motion to certify this suit as a class action. Additionally, plaintiffs have also moved to open discovery in this matter which has heretofore been limited to the class action certification issue. Finally, plaintiffs seek leave to amend the complaint a second time so as to add a Count IV.

Each of the aforementioned motions, with the exception of that seeking leave to amend, have been exhaustively briefed by the parties. The period within which defendants could respond to the motion to amend the complaint has expired. Each of the motions is thus ripe for consideration and will be, to the extent that it is possible at this time, resolved.

Plaintiff, George W. Fulk, served as the Chairman of the Profit-Sharing Committee of The Washington Group, Inc. ("the Company"). Fulk held this position from March 12, 1973 until at least September 30, 1976. Fulk also served as Chairman of the Company's Pension Committee between March 12, 1973 and June, 1977.

Plaintiff, Ruby Irene Lester, has been an hourly employee of the Company since 1941. Lester participated

---

[1] The Court recently requested that plaintiffs submit the documents governing the employee benefit plans relevant to this action. *See* the Court's order of July 30, 1980. The Court's inquiry, upon consideration of such matters beyond the pleadings, would thus be guided by the procedures for summary judgment. Fed.R.Civ.P. 12(b)(6).

Upon further consideration, however, the Court is of the opinion that reliance upon the plan documents would serve no useful purpose. The documents were solicited in connection with Count II and, as will be seen, *infra*, the sufficiency of that count is equally dependent upon factual determinations personal to each plaintiff.

Accordingly, the documents will be given no consideration at this time and the motions to dismiss will be analyzed pursuant to Rule 12(b) and not Fed.R.Civ.P. 56.

in The Washington Group, Inc. Profit-Sharing Plan for nonsalaried employees.

Plaintiff, Irene Tomlinson, is also an hourly employee of the Company of long-standing. Tomlinson, too, participated in The Washington Group, Inc. Profit-Sharing Retirement Plan for nonsalaried employees.

Plaintiff, Thomas W. Shelton, is a salaried employee of the Company. Shelton's employment with the Company began on July 22, 1957. Shelton participated in three of the Company's deferred compensation plans: The Washington Group, Inc. Profit-Sharing Retirement Plan for Salaried Employees; the Pension Plan of The Washington Group, Inc. and the Employee Stock Purchase-Savings Plan of The Washington Group, Inc.

Plaintiff, William F. Suddeth, has been a salaried employee of The Johnston Mills Company since November 26, 1956. The Johnston Mills Company was acquired by the Company on April 18, 1973. Suddeth participated in The Johnston Mills Company Profit-Sharing Plan, the Pension Plan of The Washington Group, Inc. and the Employee Stock Purchase-Savings Plan of The Washington Group, Inc.

Defendant Smith W. Bagley, was a stockholder and director of the Company and one of its principal executive officers between April 25, 1972 and December, 1975.

Defendant, James R. Gilley, was also a Company shareholder, director and a chief executive officer; between the dates of April 25, 1972 and June 20, 1977.

Defendant, American Bank and Trust Company of Pennsylvania ("American"), is a Pennsylvania corporation which has established its principal office in Reading, Pennsylvania. From September 30, 1974 until September 30, 1975, American was Trustee of the three profit-sharing plans relevant to this action. American also

served as Custodian of the Employee Stock Purchase-Savings Plan of The Washington Group, Inc. from August 29, 1974 until October 30, 1976.

Defendant, Northwestern Bank ("Northwestern") is a North Carolina corporation which maintains its principal office in North Wilkesboro, North Carolina. Between September 30, 1974 and December 31, 1977 Northwestern served as Trustee of the Pension Plan of The Washington Group, Inc. Northwestern was appointed to succeed American as Trustee to the three profit-sharing plans here in issue in September, 1975. Northwestern served in that capacity until September 30, 1976.

I. THE MOTION TO DISMISS OR TO STRIKE

Defendants have each moved to dismiss the complaint, or alternatively, to strike certain allegations thereof. These motions assert an alleged lack of subject matter jurisdiction, failure to state a claim upon which relief may be granted, failure to plead allegations of fraud with sufficient particularity and the absence of personal jurisdiction. The latter ground was raised by American and Bagley. That issue will be treated separately, *see* Part II, *infra*; as will all questions pertaining to the issue of class certification. *See* the Court's order of November 6, 1978, paragraph 7.

At the outset it is proper to reiterate the long-settled standard under which the Court must consider the sufficiency of the complaint when it is challenged pursuant to Fed.R.Civ.P. 12(b)(6). In *Conley* v. *Gibson*, 355 U.S. 41, 45-46 (1957) the standard was stated thusly:

> In appraising the sufficiency of the complaint we follow, of course, the accepted rule that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.

The Court's inquiry, then, is limited to considering whether the facts alleged, taken as true, are sufficient to state a cause of action. *See also* Fed.R.Civ.P. 8.

A. *Count I: The ERISA Claims*

Count I of the complaint alleges that defendants violated the duties imposed upon fiduciaries by ERISA. Briefly stated, the Act requires, *inter alia*, that a fiduciary administer the deferred compensation plan for the benefit of its participants; exercise skill and prudence in investing the assets of the plan; remedy, or attempt to remedy, the misconduct of co-fiduciaries; refrain from a host of prohibited transactions and administer the plan in accordance with its controlling documents.

Five deferred compensation plans are relevant to this action. For ease in discussion, the Court will employ the following abbreviated nomenclature: "Employee benefit plans" is the term which will embrace all of the deferred compensation plans. The Washington Group, Inc. Profit-Sharing Retirement Plan for Nonsalaried Employees and The Washington Group, Inc. Profit-Sharing Retirement Plan for Salaried Employees will be referred to as "the Company Plans". The Johnston Mills Company Profit-Sharing Plan will be identified by "the Johnston Mills Plan". The term, "Pension Plan" will refer to the Pension Plan of the Washington Group, Inc. Finally, the Employee Stock Purchase-Savings Plan of The Washington Group, Inc., will be denominated "the Stock Purchase Plan".

The allegations of Count I must be set forth in some detail so that defendants' challenges and the Court's views may hopefully be better comprehended. That count alleges as follows:

The Company plans were in effect prior to January 18, 1973 and were then sponsored by The Washington Mills

Company. On the aforementioned date the sponsor assumed the name of the Company and, apparently, the nomenclature of the Company plans were changed, as well. The Company plans continued in existence. Wachovia Bank and Trust Company, N.A. ("Wachovia") served as Trustee of the Company plans both prior to January 18, 1973 and for some period subsequent thereto.

The Johnston Mills Plan came under the Company's sponsorship on April 18, 1973. A subsidiary of the Company acquired the Johnston Mills Company and several of the latter's affiliates on April 18, 1973. All of the acquired companies became subsidiaries of the Company. The Company continued the Johnston Mills Plan after the acquisition.

The complaint alleges that on February 26, 1974 Gilley requested Wachovia to increase the Company Plans' holdings of shares of Company stock. Gilley purportedly requested that Company stock comprise twenty percent of the Company's Plans' assets. Wachovia subsequently purchased additional shares of Company stock for the Company Plans. Company stock did not, however, exceed ten percent of the assets of the Company Plans.

The complaint further alleges that the Company ceased making contributions to the Company Plans on September 30, 1974. The Company Plans were not terminated, however, but continued in existence for purposes of making distributions. At about this same time American was named to succeed Wachovia as Trustee. Among the assets transferred to American were 6,000 shares of Company stock then valued at $99,500.00.

American purportedly sold a substantial portion of the assets of the Company Plans in October, 1974. The complaint describes the assets which were sold as "blue chip" stocks and bonds. The sale allegedly realized $440,000.

The complaint states that this sale resulted, nevertheless, in a loss of $480,000. The complaint further alleges that American then purchased 13,800 shares of Company stock over a two month period. The average price for those purchases is said to be $19.20 per share. The Company Plans' investment in Company stock was allegedly increased to over forty percent of total assets.

The Company's contributions to the Johnston Mills Plan also allegedly ceased on September 30, 1974. The Johnston Mills Plan was continued, but only for purposes of distributing benefits. American was, at about this time, appointed successor Trustee for the Johnston Mills Plan. In September, 1974, the Johnston Mills Plan did not hold any shares of Company stock. American allegedly purchased 6,202.6 shares of Company stock in October and November, 1974, however. Those shares were purchased at an average price of $19.02. Company stock then comprised approximately forty percent of the Johnston Mills Plan's total assets.

The complaint charges that American continued to hold the Company stock on behalf of the Company Plans and the Johnston Mills Plan during 1975, despite the fact that the stock's market value began to decline. In July, 1975 American purportedly sold 1,784 shares of Company stock held by the Company Plans for approximately eight dollars per share.

In September, 1975, Northwestern succeeded American as Trustee for the Company Plans and the Johnston Mills Plan. Among the assets transferred to Northwestern were, allegedly, more than 20,000 shares of Company stock. The complaint alleges that Northwestern failed to evaluate the assets of the Company Plans and the Johnston Mills Plan and failed to divest the plans of their Company stock despite a steadily declining market value.

The Company Plans and the Johnston Mills Plan were terminated in the fall of 1976. The market value of the Company's shares had purportedly fallen to approximately three dollars per share at that time.

During this period the Company also maintained the Pension Plan for the benefit of the Company's employees and the employees of its subsidiaries. Wachovia served as Trustee for the Pension Plan until September 30, 1974 when it was succeeded by Northwestern. Four thousand shares of Company stock were among the assets transferred to Northwestern.[2] The complaint charges Northwestern with failing to review Wachovia's investment decisions, failing to review the Pension Plan's investments and failing to dispose of poor investments.

The Company established the Stock Purchase Plan on August 29, 1974. American was appointed Custodian of this plan. As Custodian, American allegedly purchased shares of Company stock with funds derived from voluntary participant contributions and matching contributions from the Company. American purportedly continued to purchase Company stock while its market value declined steadily. On October 30, 1976 the Stock Purchase Plan was terminated. The Stock Purchase Plan allegedly then held more than 40,000 shares of Company stock.

Upon the aforementioned allegations plaintiffs contend that the Act was violated in five respects. Each of the alleged violations is, in turn, founded upon two or more alternative accusations. The instant motion may be disposed of without the Court considering each allegation in great specificity.

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[2] The Pension Plan subsequently acquired an additional 400 shares of Company stock as the result of a November 15, 1974 stock dividend.

Three of the fiduciary duties allegedly breached by defendants are set forth in § 404(a) of ERISA, 29 U.S.C. § 1104(a). The pertinent provisions of that section are as follows:

> Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan;
>
> (B) with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
>
> * * *
>
> (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter.

Plaintiffs further contend that defendants are liable under the standards of § 405(a) of ERISA, 29 U.S.C. §§ 1105(a). Section 405 governs a fiduciary's liability for the breach of duty by a co-fiduciary. Subsection (a) provides for such liability under the following circumstances:

> (1) if he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach;
>
> (2) if, by his failure to comply with section 1104 (a)(1) of this title in the administration of his specific responsibilities which give rise to his status as a fiduciary, he has enabled such other fiduciary to commit a breach; or

(3) if he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

The Fifth alleged violation of ERISA arises under § 406 (a), 29 U.S.C. § 1106(a). Section 406(a)(1)(D) of ERISA prohibits a fiduciary from knowingly causing a plan to engage in a transaction which, directly or indirectly, constitutes a "transfer to, or use by or for the benefit of, a party in interest" of any plan assets.

ERISA was enacted to provide a comprehensive statutory scheme for the protection of private pension rights. *Martin* v. *Bankers Trust Company*, 565 F.2d 1275, 1278 (4th Cir. 1977). Among the Act's provisions are prescribed minimum standards for participation, funding, vesting and, what is relevant here, fiduciary conduct. Congress strengthened these minimum standards by explicitly creating a cause of action to enforce same in favor of participants, beneficiaries and fiduciaries. 29 U.S.C. § 1132(a); § 502(a) of the Act. Jurisdiction over those causes of action is, for the most part, vested exclusively in the federal district court. ERISA § 502(e)(1); 29 U.S.C. § 1132(e)(1).

In this circuit it is clear that the jurisdiction conferred by § 502(e)(1) of the Act is operative only upon a federal cause of action created by ERISA. *Martin*, *supra* at 1278. ERISA's standards of fiduciary conduct did not take effect until January 1, 1975. *Malone* v. *White Motor Corporation*, 435 U.S. 497 (1978); ERISA § 514; 29 U.S.C. § 1144. From these principles defendants surmize the Court lacks subject matter jurisdiction as to allegations of events prior to 1975. Defendants would have the Court dismiss Count I in its entirety or, in the alternative, strike all allegations of pre-1975 events.

On its face the complaint sets forth allegations of conduct and events which occurred prior to the effective date

of the pertinent sections of ERISA. However, each of the defendants concedes, either explicitly or implicitly, that the complaint contains allegations of post-1974 conduct as well. *See* Brief of Defendant Smith W. Bagley In Support of Motion to Dismiss and Strike at 6, n.4; Brief of Defendant American Bank and Trust Company of Pennsylvania at 3. Northwestern did not contest the allegations of pre-1975 acts and Gilley, in this regard, chose to rely upon the other defendants' contentions. Dismissal for want of subject matter jurisdiction would thus be inappropriate and will be denied.

Fed.R.Civ.P. 12(f) authorizes the Court to strike from a pleading, "any insufficient defense or any redundant, immaterial, impertinent, or scandalous matter." A close inspection of the complaint's allegations and ERISA's requirements demonstrates that the allegations of pre-1975 conduct cannot be characterized as "redundant, immaterial, impertinent or scandalous."

First, the complaint may easily be read as alleging a single scheme of misuse of the assets of the employee benefit plans and breach of duty by fiduciaries. Similar allegations were presented in *Marshall* v. *Craft*, 463 F. Supp. 493 (N.D. Ga. 1978). In *Marshall, supra*, the complaint withstood a motion to dismiss because the allegations of post-1974 misconduct stated a cause of action under ERISA. The Court also held that ERISA could be violated even though the breach had its origin in an event preceding ERISA's effective date:

> To hold otherwise would be in large measure to insulate post-1974 actions from review simply because their roots could be traced to an event prior to the effective date of ERISA, a clearly improper result given the purpose and nature of the statute.

Marshall, supra at 497. The Court is of the opinion that the reasoning of *Marshall, supra* applies with equal force to the instant matter. Pre-1975 actions by the defendants

may well be relevant to Count I even though, standing alone, they are not actionable under ERISA.

Contrary to defendants' assertions, it does not appear that plaintiffs seek to establish the former's ERISA liability upon pre-1975 actions. Plaintiffs may not rely upon a "continuing liability" theory of ERISA, for such is precluded by *Martin, supra.* The Court is of the opinion, however, that plaintiffs may contend that certain pre-1975 actions triggered duties imposed upon fiduciaries by ERISA.

In *Morrissey* v. *Curran,* 567 F.2d 546 (2d Cir. 1977) the plaintiffs contended that the trustees of an employee benefit plan breached their ERISA-imposed fiduciary duties by failing to divest the plan of an imprudent and unproductive investment. The investment was made prior to the effective date of the pertinent section of the Act. Nevertheless, the Court stated:

> We have no doubt that under the "prudent man" rule, which is codified in ERISA, the trustees here had a duty within a reasonable time after ERISA took effect to dispose of any part of the trust estate which would be improper to keep.

Id. at 548-49 (footnotes omitted). The Court adopts the reasoning that a fiduciary's pre-1975 actions may, under ERISA, necessitate action on his part after the effective date of the Act.

Plaintiffs advance a second ground for resisting the present motion with regard to the allegations of pre-1975 actions. Plaintiffs' second basis rests upon the Act's provision for liability for breaches of duty by a co-fiduciary. Upon consideration of this proposition, and for the reasons which follow, the Court deems plaintiffs' argument to be well-taken.

Section 405(a)(3) of the Act, 29 U.S.C. § 1105(a)(3), provides that a fiduciary shall be liable for a breach of

duty by his co-fiduciary if he knows of the latter's misconduct and yet fails to make a reasonable attempt to cure the breach. The question presented for immediate consideration is whether § 405(a)(3) may support a claim premised upon the co-fiduciary's pre-ERISA misconduct. The Court is persuaded by Judge Lumbard's concurrence in *Morrissey, supra* and concludes that § 405(a)(3) may support such a cause of action. In reaching this conclusion the Court is mindful of the rule announced in *Martin, supra* at 1278 (29 U.S.C. § 1144 precludes federal jurisdiction over a claim based upon pre-ERISA actions), but does not find it to require a contrary conclusion.

Section 405(a)(3) speaks of a breach of the co-fiduciary's duty. It does not limit itself to a breach of ERISA; unlike other sections of the Act. *See, e.g.*, 29 U.S.C. § 1132. The inference which is readily drawn from § 405(a)(3)'s language is that ERISA requires a fiduciary to act when his co-fiduciary, prior to January 1, 1975, breaches a duty owed to the beneficiaries of a plan.

The Court does not believe this to be an unreasonable or too-broadening interpretation of § 405(a)(3). The Act, of course, explicitly provides for the fiduciary's liability for breaches of his co-fiduciary. The application of § 405(a)(3) is limited to those instances in which the fiduciary has knowledge of his co-fiduciary's misconduct. With that limitation, the burden upon the fiduciary is no greater than that imposed to remedy his own pre-ERISA breaches. Section 405(a)(3) further limits the fiduciary's duty to act "to reasonable efforts under the circumstances." Finally, the Court emphasizes that liability under § 405(a)(3) is neither derivative nor predicated upon the fiduciary's pre-ERISA misconduct. Rather, the Court's interpretation is that the fiduciary's duty to act, and his liability for failure to do so, arises on or after January 1, 1975. The fact that the ERISA duty is

triggered by a pre-1975 event should not permit the fiduciary to avoid his duties under the Act.

ERISA's fiduciary obligations, by definition, extend only to "fiduciaries". Bagley and Gilley maintain that the complaint simply identifies them as fiduciaries in a conclusory fashion without alleging facts to support that conclusion. Thus, they contend, Count I fails to state a cause of action against them and should be dismissed.[3] For the reasons which follow, the Court disagrees and thus, these motions will be denied.

ERISA contains a most specific definition of the term "fiduciary". Section 3(21)(A) of the Act, 29 U.S.C. § 1002(21)(A), provides, in pertinent part:

> a person is a fiduciary with respect to a plan to the extent that (i) he exercises any discretionary authority or control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such a plan.

The Court is of the view that the complaint alleges facts which, if proven, would show Bagley and Gilley to be fiduciaries within the meaning of ERISA § 3(21)(A).

The Department of Labor, which is responsible for administering ERISA in conjunction with the Internal Revenue Service, periodically issues Interpretive Bulletins. One such bulletin posed and answered questions regarding the breadth of fiduciary status:

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[3] American and Northwestern apparently concede that their trusteeships rendered them "fiduciaries" within the contemplation of The Act.

> Q: In the case of a plan established and maintained by an employer, are members of the board of directors of the employer fiduciaries with respect to the plan?
>
> A: Members of the board of directors for an employer which maintains an employee benefit plan will be fiduciaries only to the extent that they have responsibility for the functions described in section 3 (21) (A) of the Act. For example, the board of directors may be responsible for the selection and retention of plan fiduciaries. In such a case, members of the board of directors exercise "discretionary authority or discretionary control respecting management of such plan" and are, therefore, fiduciaries with respect to the plan. However, their responsibility, and consequently, their liability, is limited to the selection and retention of fiduciaries (apart from co-fiduciary liability arising under circumstances described in section 405(a) of the Act.

29 C.F.R. § 2509.75-8 (1979) at D-4. The Interpretive Bulletin is consistent with the definitions of "fiduciary" contemplated by the Congress. *See* H.R. Rep. No. 93-1280, 93d Cong., 2d Sess. 323, *reprinted in* [1974] U.S. Code Cong. & Admin. News 5038, 5103.

Count I alleges that Bagley and Gilley were members of the Company's board of directors. It is conceivable that plaintiffs may prove that Bagley and Gilley, as directors, exercised or possessed the requisite authority and responsibility with respect to the plan such that they may be deemed "fiduciaries". The same may also be said of Bagley and Gilley holding the two principal executive offices in the Company. The Court is cognizant that these positions, in and of themselves, will not render an officer or director a fiduciary. *See* 29 C.F.R. § 2509.75-8 (1979) at D-5. That, however, presents an issue of proof, the consideration of which is premature at this stage in the litigation.

It is also apparent that in defining "fiduciary" Congress was peculiarly concerned with realities, as distinguished from mere formalities. Thus Congress determined that fiduciary status should extend to all those exercising control over employee benefit plans without regard to their office or formal relationship with the plan. For example, H.R.Rep. 93-1280, *supra* provides that, "the definition [of 'fiduciary'] includes persons who have authority and responsibility with respect to the matter in question regardless of their formal title." *See also, Eaves* v. *Penn*, 558 F.2d 453 (10th Cir. 1978) ("[O]fficers and directors of the plan sponsor are fiduciaries if they exercise control through the selection of the investment committee, administrative committee or plan officers or directors.")

The complaint may be read as alleging that Bagley and Gilley possessed authority to select, or participate in the selection of trustees or custodians for the employee benefit plans. The complaint infers, especially as to Gilley, that this authority was used to influence the investment of plan assets. In addition to their Company offices and directorships, sufficient *de facto* control might also be established by proof, if any there be, that Bagley and Gilley, as shareholders, controlled the Company. For the foregoing reasons the Court is of the opinion that Count I of the complaint alleges sufficient facts to state a cause of action against Bagley and Gilley. Their Rule 12(b)(6) motions will therefore be denied.

B. *Count II: The Securities Claims*

Count II purports to state a claim for relief under The Securities Exchange Act of 1934 ("the 1934 Act"), 15 U.S.C. §§ 78a *et seq.*, and the rules promulgated thereunder. The allegations heretofore summarized in the preceeding section are relied upon by plaintiffs as violating § 10b of the 1934 Act, 15 U.S.C. § 78j(b) as well

as Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. § 240.10b-5.

The complaint, in paragraph 50, charges defendants with misrepresenting unto the plaintiffs that the assets of the employee benefit plans would be prudently invested by the plans when, in fact, the plans were the subject of self-dealing and other breaches of fiduciary obligations. Count II further alleges that defendants failed to advise plaintiffs that assets of the employee benefit plans were being invested in stock which was not of a fiduciary quality.

Section 10(b) of the 1934 Act proscribes a wide range of conduct which occurs "in connection with the purchase or sale of *any security* . . . ." (emphasis added). In order to prosecute this action, then, plaintiffs must not only demonstrate a purchase or sale, *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), but they must also show that said transaction involved a security.

To meet this threshold requirement plaintiffs would characterize their participation rights in the respective employee benefit plans as "investment contracts".[4] The 1934 Act, in § 3(a)(10), 15 U.S.C. § 78c(a)(10), includes "investment contracts" within its definition of a "security". Defendants, relying upon *International Brotherhood of Teamsters* v. *Daniel*, 439 U.S. 551, 99 S.Ct. 790, 47 U.S.L.W. 4135 (1979), would have the Court dismiss Count II on the grounds that such a participation right is not an investment contract.

In *Daniel*, *supra* the Court held that an employee's interest is a compulsory, noncontributory deferred compen-

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[4] The complaint is ambiguous with regard to whether plaintiff Fulk seeks to pursue a § 10(b) claim on behalf of the employee benefit plans themselves. Nor does it appear that any party has addressed this point. The ambiguity may perhaps be resolved by either subsequent defensive pleadings or by amending the complaint.

sation plan was not an investment contract within the meaning of the 1934 Act. Respondent there was thus precluded from prosecuting a suit under the antifraud provisions of both the 1934 Act and the Securities Exchange Act of 1933, 15 U.S.C. § 77, *et seq.*

In reaching this conclusion, the Court, as it has repeatedly in the past, followed the analysis enunciated in *SEC* v. *W. J. Howey Co.*, 328 U.S. 293 (1946). To determine whether an interest constitutes an investment contract, "[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Howey, supra* at 301.

In *Daniel, supra* the pension plan was noncontributory, *i.e.* employees did not contribute money or other consideration to the plan. The plan was instead funded solely[6] from employer contributions. The employer's contributions did not constitute an "investment of money" by or on behalf of the employee because the former's obligation was to the fund, rather than the employee, and because there was no fixed relationship between the contributions and the employee's benefits. The Court was also clear that it would indeed be the rare situation where the employee's labor would satisfy the first branch of *Howey, supra.*

It is also clear from *Daniel, supra* that in order to fulfill the "investment of money" aspect of *Howey, supra* the plan must not only *provide* for employee contributions, but the particular employee/plaintiff must also have *contributed.* In this regard the court stated:

> In every decision of this Court recognizing the presence of a "security" under the Securities Acts, the person found to be an investor chose to give up a

[6] The plan earned income upon its assets but the contributions were derived solely from the employer.

> specific consideration in return for a separable financial interest with the characteristics of a security. . . . In every case the purchaser gave up some tangible and defineable consideration in return for an interest that had substantially the characteristics of a security.

439 U.S. at 559, 47 U S.L.W. at 4137 (citations omitted).

The expectation of profits from a common enterprise is the more significant inquiry, however. *United Housing Corporation* v. *Forman*, 42 U.S. 837, 852 (1975). This element of an investment contract was not present in *Daniel, supra* since the largest portion of the plan's income was derived from employer contributions rather than earnings on the plan's assets. Also significant was the employer's obligation to cover shortfalls in earnings; a trait common to many pension plans. Finally, the Court noted that substantial vesting requirements, rather than investment success, is often the greatest obstacle in realizing an employee's benefits expectations.

The *Daniel, supra* and *Howey, supra,* analysis has been applied to a limited number of pension related claims brought pursuant to the federal securities laws. In *Black* v. *Payne*, 591 F.2d 83 (9th Cir. 1979) the court found that interests in a compulsory, but contributory pension plan did not constitute an investment contract because benefits were not keyed to the profits of a common enterprise. *Id.* at 87. In *Tanuggi* v. *Grolier Incorporated*, 471 F.Supp. 1209 (S.D. N.Y. 1979) a voluntary and contributory pension plan was deemed not to be an investment contract. This conclusion rested in large measure upon the factual findings that, "the benefits an employee . . . [receives] have only a tenuous connection to the investment success of the pension fund," *Id.* at 1214, and that the employer was obligated to cover shortfalls in earnings. *Cf.* 17 C.F.R. § 231.6188, [current binder]. CCH Fed.Sec.L.Rptr. § 1051 at 2073-10 (SEC

release February 1, 1980) (Interpreting § 3(a)(10) of the 1934 Act in light of *Daniel, supra*).

The preceding discussion is sufficient to demonstrate that the *Daniel, supra* and *Howey, supra* inquiry necessitates an initial factual inquiry. Is the relevant plan compulsory or voluntary? Is the plan contributory or noncontributory? If it is contributory, did the plaintiff in fact make contributions? To what extent are benefits from the relevant plan related to the plan's investment success? Are the vesting requirements substantial; either in theory or in fact? Undoubtedly, many more pertinent questions will arise as the factual record for each plan is developed. In any event, the Court cannot at this time, in keeping with the applicable standard, determine with certainty that the employee benefit plans in the instant matter are not investment contracts.[6] Defendants' motions in this regard must therefore be denied.[7]

Northwestern further asserts that Count II does not satisfy the particularity requirement of Fed.R.Civ.P. 9(b). That Rule provides that

> In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge and

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[6] Plaintiffs' opposition to motions to dismiss concedes that the Pension Plan in this matter was noncontributory. It will thus be difficult for plaintiffs to demonstrate "an investment of money" or any other investment decision. A ruling upon whether a participant's interest in the Pension Plan constituted an investment contract must await another time. Plaintiffs will still be afforded an opportunity to satisfy the *Howey, supra* rationale. The Court's initial impressions here stated should not be construed as intimating its final conclusion in this regard.

[7] The Court will not, and need not, address the various contentions regarding the "purchase or sale" requirement of *Blue Chip Stamps, supra*, or the other elements of a § 10(b) action, until it has been determined that the participation interests were investment contracts.

> other condition of mind of a person may be averred generally.

An identical challenge was rejected by the Court in *Gilbert* v. *Bagley*, Civil Action No. 78-335-WS (M.D.N.C. 1980). In its June 2, 1980 memorandum the Court emphasized that Rule 9(b)'s particularity requirement must be considered in light of its intended purpose and in conjunction with Fed.R.Civ.P. 8. The Court adheres to that approach.

Rule 9(b) is intended to satisfy two salutory objectives. First, it insures that a defendant is afforded fair notice of the nature of the plaintiff's claim and the grounds upon which it is based. *See e.g.*, *Denny* v. *Barber*, 576 F.2d 465, 469 (2d Cir. 1978). Second, the particularity requirement insures that allegations of fraud will not be advanced lightly or without some factual basis. *See e.g.*, *Segal* v. *Gordon*, 467 F.2d 602 (2d Cir. 1972); *Clark* v. *Cameron-Brown Co.*, 72 F.R.D. 48 (M.D.N.C. 1976). *See also* 5 C. Wright and A. Miller, *Federal Practice and Procedure*, Civil § 1296 (1969).

The particularity requirement should not be interpreted without regard to the notice pleading theory espoused by Rule 8. Instead, the two Rules should be read as being complementary:

> It is inappropriate to focus exclusively on the fact that Rule 9(b) requires particularity in pleading fraud. This is too narrow an approach and fails to take account of the general simplicity and flexibility contemplated by the rules.

5 C. Wright and A. Miller, *Federal Practice and Procedure*, Civil § 1298 (1969).

The Court remains of the view that a plaintiff complies with Rule 9(b) when the complaint gives the defendant the fair notice to which he is entitled and, at the same time, evidences a reasonable belief on the part of

the plaintiff that there is merit to his claim. As the court observed in *Cameron-Brown, supra:*

> In class action securities cases it is not always practical to require the plaintiffs to plead with absolute particularity even though their allegations are based on information and belief. The sufficiency of a pleading turns upon consideration of a number of factors, not the least of which is whether the action seeks to redress a wrong, not to find one.

Cameron-Brown, supra at 61. To require greater specificity would undermine the pleading theory embraced by Rule 8. A more complete statement of this view may be found in *Poller* v. *First Virginia Mortgage and Real Estate Invesment Trust,* [1978 Transfer Binder] CCH, Fed.Sec.L.Rptr. § 96,564 (E.D. Va. 1978).

Upon a review of the complaint, the Court is of the opinion that Count II satisfies the particularity requirement of Rule 9(b) as it is discussed in the preceding paragraphs. The complaint alleges a single, on-going scheme to manipulate the market value of the Company's stock. The complaint further alleges the transactions deemed to be an integral part of the scheme; as well as the approximate dates thereof. Count II, in large part, appears to be premised on defendants' alleged failure to disclose material information during the entire period covered by the complaint. The truth or falsity of the alleged omission is a matter peculiarly within the knowledge of the defendants. Accordingly, the pleading requirements should be given a liberal interpretation. *Fox* v. *Prudent Resources Trust,* 382 F.Supp. 81, 95 (E.D. Pa. 1974); 2A Moore, *Federal Practice* § 9.03.

C. *Count III—Common Law Fiduciary Duty*

Defendants have challenged the sufficiency of Count III's allegations on several grounds. The Court has considered each of these contentions as well as the memo-

randa submitted by the parties in support of their respective positions. For the reasons which follow, the Court is of the opinion that the motions to dismiss Count III must also be denied.

Each of the defendants would have the Court dismiss Count III for lack of subject matter jurisdiction. For the most part, this argument is premised upon defendants' positions with regard to dismissal of Counts I and II and the fact that Count III arises under the common law of North Carolina. The Court's view with respect to Count I and II, however, destroys defendants' syllogism regarding the exercise of pendent jurisdiction.

Counts I and II arise under federal law and subject matter jurisdiction over those claims vests in the court pursuant to 29 U.S.C. § 1132(e)(1) and 15 U.S.C. § 78aa. The Court is satisfied that the allegations of Count III and the federal claims arise from "a common nucleus of operative fact." *United Mine Workers* v. *Gibbs*, 383 U.S. 715, 725 (1966). From this the Court concludes that it has the power to entertain Count III.

In *Gibbs*, *supra*, the court made clear that the district court possesses discretion as to whether to exercise the power presented under the pendent jurisdiction doctrine. American contends that the Court should decline to take jurisdiction over Count III. In this regard American argues that Count III's state law claims will assume a predominant role in this matter since the pre-1975 allegations are not actionable under ERISA.

The Court cannot accept American's conclusions for several reasons. Evidence of defendants' pre-1975 actions will likely be introduced in connection with Count I without regard to Count III. Pre-1975 events may also be relevant as to Count II, if that claim proceeds to the merits. Judicial economy and fairness also weigh in favor of the exercise of pendent jurisdiction in this matter. This is especially true since 29 U.S.C. § 1132 re-

quires that Count I be prosecuted in the district court and 29 U.S.C. § 1144 supersedes the relevant state law cause of action effective January 1, 1975.

Northwestern and American further contend that the complaint fails to state a cause of action for breach of fiduciary duty under North Carolina law. The Court need not dwell on this issue. The complaint charges defendants with intentional self-dealing, mismanagement and fraud and negligently falling short of the prudence and diligence required of fiduciaries. This is sufficient to withstand a motion under Fed.R.Civ.P. 12(b)(6). *Wachovia Bank and Trust Company* v. *Johnston*, 269 N.C. 701, 153 S.E.2d 449, 457 (1967); *Poindexter* v. *First National Bank of Winston-Salem*, 244 N.C. 191, 92 S.E.2d 773, 775 (1956); *Tayloe* v. *Tayloe*, 108 N.C. 69, 12 S.E. 836, 838 (1891).

Northwestern and American also contend that Count III fails to plead fraud with the particularity required by Fed.R.Civ.P. 9(b). Initially it must be emphasized that Count III rests upon allegations of several types of misconduct. It is not limited to fraud. The Court considered this challenge pursuant to the standard discussed in subpart B., *supra*. Northwestern's and American's challenges have been found to be without merit.

The complaint alleges that defendants, all of whom are claimed to be fiduciaries, had interests and objectives which were inconsistent with those of the trust beneficiaries. The complaint sets forth the approximate dates on which shares of Company stock were bought and sold. The complaint also states when other assets of the employee benefit plans were sold. The complaint questions whether the prudent investor standard would permit the Company Plans and the Johnston Mills Plan to hold such a large percentage of their assets in Company stock. The Court is of the opinion that defendants have been given fair notice of the plaintiffs' claims. The complaint

is sufficiently precise to evidence a reasonable belief that a wrong has been committed. As has been seen, Rule 9(b) requires nothing more.

II. PERSONAL JURISDICTION

Bagley and American also seek dismissal of the complaint for want of personal jurisdiction. Fed.R.Civ.P. 12(b)(2). In this regard Bagley asserts that he has not resided in North Carolina since 1975 and that he no longer maintains an office in the state. American, for its part, avers that it transacts no business in North Carolina, is not authorized to do so and that its relationship with the Company was centered upon Pennsylvania. Bagley and American thus conclude that they are not amenable to suit under the North Carolina long-arm statute, N.C.G.S. § 1-75.4. They further argue that the exercise of jurisdiction over them would abridge the due proces guarantees of *International Shoe Co.* v. *Washington*, 326 U.S. 310 (1945). These arguments were presented to the Court in *Gilbert, supra*, and rejected. Defendants' assertions are not more persuasive in the instant case.

Fed.R.Civ.P. 4(f) provides for service of process anywhere within the territorial limits of the state where the district court is held and, "when authorized by a statute of the United States . . . beyond the territorial limits of that state." Rule 4(f) thus recognizes the power of Congress to provide for nationwide service of process in an action to enforce a federal right. *Mississippi Publishing Corporations* v. *Murphree*, 326 U.S. 438 (1946). This power was recognized in *Robertson* v. *Railway Labor Board*, 268 U.S. 619 (1925), and rests upon a sovereign's fundamental right to exercise jurisdiction over defendants within its territory. *First Flight Co.* v. *National Carloading Corporation*, 209 F. Supp. 730, 736 (E.D. Tenn. 1962).

Section 502(e)(2) of ERISA, 29 U.S.C. § 1132(e)(2) provides for such nationwide service of process:

> Where an action under this title is brought in a district court of the United States, it may be brought in the district where the plan is administered, where the breach took place, or where a defendant resides or may be found, and process may be served in any other district where a defendant resides or may be found.

Congress intended to open the federal forum to ERISA claims to the fullest extent possible. S.Rep.No. 93-127, 93d Cong., 1st Sess. 35, *reprinted in* [1973] U.S. Code Cong.& Admin.News.

Likewise, § 27 of the 1934 Act, 15 U.S.C. § 78aa, provides, in pertinent part:

> Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.

There are thus explicit provisions for bringing Bagley and American before this court with regard to Counts I and II of the complaint.

The Court is of the further opinion that the doctrine of pendent personal jurisdiction affords a basis for rendering Bagley and American amenable to Count III. Recent cases have held that § 27 of the 1934 Act may confer personal jurisdiction over a defendant for more than simply securities law claims. *Robinson* v. *Penn Central Co.*, 484 F.2d 553 (3d Cir. 1973); *Schwartz* v. *Eaton*, 264 F.2d 195 (2d Cir. 1959) (dictum); *Warren* v. *Bokum Resources Corp.*, 433 F.Supp. 1360 (D.N.M. 1977); *Bertozzi* v. *King Louie Intern., Inc.*, 420 F.Supp. 1166

(D.R.I. 1976); *Sohns* v. *Dahl*, 392 F.Supp. 1208 (W.D. Va. 1975); *Oxford First Corp.* v. *PNC Liquidating Corp.*, 372 F.Supp. 191 (E.D. Pa. 1974); *Getter* v. *R.G. Dickinson & Co.*, 366 F.Supp. 559 (D.Iowa 1973); *Allen Organ Co.* v. *North American Rockwell Corp.*, 363 F. Supp. 1117 (E.D. Pa. 1973); 2 Moore, *Federal Practice and Procedure*, Civil § 1125. *Contra*, *Trussel* v. *United Underwriters, Ltd.*, 236 F.Supp. 801 (D.Colo. 1964) and cases cited in *Bertozzi*, *supra* at 1171-72, n.l. In the instant case pendent personal jurisdiction serves both the substantive schemes of ERISA and the 1934 Act and the considerations of judicial economy underlying pendent subject matter jurisdiction.

Defendants' due process claims are, in the Court's view, without merit. First, the Court does not consider *International Shoe*, *supra* controlling. The issue there presented was the fairness of a state court's exercise of extraterritorial jurisdiction. That question is readily distinguishable from the case at bar where the sovereign—the United States of America—is simply invoking its judicial power within its territory. *International Shoe*, *supra* would be relevant where a federal district court, *e.g.*, attempts to exercise jurisdiction over a Canadian citizen by service of process perfected in that country. *SEC* v. *Myers*, 285 F.Supp. 743 (D. Md. 1968).

Fitzsimmons v. *Barton*, 589 F.2d 330 (7th Cir. 1979), too, counsels that defendants' constitutional challenge must be rejected. The court there rejected a similar argument by an Oklahoma defendant which was directed to the exercise of jurisdiction by the Illinois district court:

> Here the sovereign is the United States, and there can be no question but that the defendant, a resident citizen of the United States, has sufficient contacts with the United States to support the fairness of the exercise of jurisdiction over him by a United States court.

Id., at 333 (footnote omitted). And, if due process requires more, it is present in this action. Discovery constitutes the largest effort in complex litigation today. The discovery burden will be largely unaffected by the venue. Furthermore, Bagley concededly had substantial ties to North Carolina. American, as trustee or custodian of several of the Company's employee benefit plans surely appreciated that its duties would have a far greater impact beyond Pennsylvania than within. Finally, judicial economy is served by the presence of all the defendants in one action. Bagley's and American's motions pursuant to Fed.R.Civ.P. 12(b)(2) will therefore be denied.

III. CERTIFICATION AS A CLASS ACTION

The motion for certification of this suit as a class action must continue under advisement. In *In re The Washington Group, Inc.*, in Chapter X Reorganization Numbers B-77-695 through B-77-702 (September 5, 1979) the Court determined that the Company's Reorganization Trustee, Richard A. Gilbert, may not defray the litigation expenses of the plaintiffs in this action. The appeal of that order is pending before the United States Court of Appeals for the Fourth Circuit.

The principal issue presented in a motion for class certification is the ability of the designated plaintiffs to represent the interests of the entire class. As a practical matter, the ability and willingness of the plaintiffs to bear the expenses of this action, is essential to their fair representation of the class.

The inability of the Company's Trustee to defray the costs of this litigation brings the plaintiffs' ability and willingness to do so into question. This is particularly true where, as here, the designated plaintiffs appear to have been assured prior to the commencement of the action that they would not be responsible for litigation expenses.

The Court cannot, upon the present record, make a finding as to the ability and willingness of the named plaintiffs to shoulder the costs of this matter. Accordingly, the record must be supplemented and the Court will entertain a motion to reopen discovery on the class certification, if necessary.

IV. MOTION TO OPEN GENERAL DISCOVERY

Previous orders of this Court have heretofore limited discovery in this action to the issue of class certification. Plaintiffs have moved to open general discovery on the merits of the case. Plaintiffs also seek an order requiring defendants to respond to pending discovery requests within thirty (30) days from the order opening discovery. The Court has reviewed the parties' memoranda and concluded that plaintiffs' motion is well taken.

Defendants offer three grounds for opposition to this motion. Two of these contentions are moot. The related criminal action, which was the principal reason for the Court's stay of discovery, has concluded. Defendants' motions to dismiss have been addressed in this memorandum and thus are no longer an obstacle to discovery.

Defendants' third basis for resisting the opening of discovery relates to the still unresolved issue of class certification. Defendants rely upon § 1.40 of the Manual for Complex Litigation (1977) which states:

> It is recommended that no discovery on the merits be permitted during the discovery of the class action issue, except as is relevant to the class action determination.

The Court recognizes that in most instances the Manual states the preferred approach. Nevertheless, the Court is persuaded that extenuating circumstances counsel in favor of a departure from normal procedure.

The original complaint in this action was filed on July 26, 1978. The issues have remained unresolved for two years; although as defendants contend, not an unreasonable time in such complex litigation. In light of the interests involved, however, *e.g.*, plaintiffs' retirement benefits, further delay cannot be countenanced.

Furthermore, additional discovery is likely to occur with regard to the class certification issue. That fact, and the discovery previously taken, should prevent the substantive discovery from becoming too burdensome or inefficient even if this matter does not proceed as a class action. Finally, the parties may diminish any inefficiency in proceeding with discovery by supplementing the record on the certification question to the end that the issue may be promptly resolved.

V. LEAVE TO AMEND THE COMPLAINT

Plaintiffs seek leave to amend the complaint, a second time, in order to add a Count IV. The new count would purportedly state a claim under § 5 of The Securities Act of 1933, 15 U.S.C. § 77e.

This matter is, relatively speaking, still in its infancy. Substantive discovery is soon to begin. Defendants, by virtue of the pendency of the instant motion, have not yet answered the complaint. The Court is of the opinion, therefore, that it would be proper to permit such amendment.

An appropriate order shall issue.

/s/ Robert R. Merhige
ROBERT R. MERHIGE
United States District Judge

Date: 9/2/80

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80-1755

NO. 80-_____

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1980

GEORGE W. FULK, THOMAS W. SHELTON,
AND WILLIAM F. SUDDETH,

PETITIONERS

V.

DAVID R. JOHNSTON, THE NORTHWESTERN BANK
AND JAMES R. GILLEY,

RESPONDENTS

MEMORANDUM IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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IN THE
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OCTOBER TERM, 1980

NO. 80-_____

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RESPONDENTS

MEMORANDUM IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

R. A. Gilbert, Trustee in Reorganization of The Washington Group, Inc. and its subsidiaries, as an interested party, hereby tenders this Memorandum in support of the Petition of George W. Fulk, Thomas W. Shelton and William F. Suddeth for a Writ of Certiorari to review the Judgment of the

United States Court of Appeals for the Fourth Circuit in this case.

OPINIONS BELOW

All relevant opinions below are accurately identified in the Petition.[1]

JURISDICTIONAL STATEMENT

The jurisdictional statement filed with the Petition is hereby adopted by the Respondent.[2]

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The relevant statutory provisions are accurately set forth in the Petition.[3]

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[1] Petition at 1.

[2] Id. at 1.

[3] Id. at 2.

STATEMENT OF THE CASE

The Respondent hereby adopts the Statement of the Case set forth in the Petition,[4] with the following exceptions. First, it is stated on page 3 of the Petition that "In his report, the Trustee found substantial evidence of 'mismanagement on the part of certain of the officers/directors of the [Companies] or others acting in fiduciary capacities,' particularly in connection with the Companies' employee benefit plans. (Footnote deleted) Trustee's Report at 55." The language quoted does not refer to the employee benefit plans but refers only to the total claims to be asserted by the Trustee on behalf of the reorganizing Companies against certain former

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[4] Id. at 2.

officers and directors. The employee benefit plans are not mentioned by the Trustee until Page 98 of his Report.[5] Secondly, it is also noted on page 3 of the Petition that "proceeds from the sale of these 'blue chip' stocks were then invested in the common stock of the Companies." This statement is only partially correct. A portion of the proceeds were also invested in nonequity assets. Thirdly, it is stated on page 4 of the Petition that "additional authorization was sought 'to expend funds of the

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[5] The Trustee conducted an investigation of the debtors pursuant to Rule 10-208(a) of the Federal Rules Of Bankruptcy Procedure. The Trustee's Report, which was filed on June 20, 1978, is a part of the record in this case and can be found at pages 11-257 of the Appendix to the Appellants' Brief in the proceeding below.

[Companies] to assist in the prosecution of actions... for the recovery of losses resulting from these mismanaged profit-sharing plans....'" (citations omitted) The Trustee's Report contained a recommendation that he be authorized to expend the funds of the Companies, but did not actually request such authorization. However, subsequent to the filing of the Report, the Trustee did in fact make applications for such funding to the Bankruptcy Court. Lastly, it is noted on page 4 of the Petition that "Relying on this Order and the Trustee's stated willingness to defray the costs of an employee law suit, certain present and former Washington Group employees--- the petitioners before this Court---filed a civil class action...." This language

would seem to indicate that the Trustee had some authority independent of the July 21, 1978 Order to assist in the funding of the employees' law suit. The Trustee, of course, has no such independent authority. The Trustee's application to the Bankruptcy Court that he be authorized to take such action gives rise to this proceeding. With the exception of the minor corrections noted above, the Respondent adopts the remainder of the Statement of the Case set forth in the Petition.

REASONS FOR RESPONDENT'S SUPPORT FOR THE GRANTING OF THE WRIT

Respondent adopts in large part the arguments set forth by the Petitioners in support of their Petition for a Writ of

Certiorari. In order to avoid an undue repetition of the Petitioners' arguments, the Respondent would note in summary fashion the following grounds for the allowance of the Writ. First, the lower courts' determination that it was inappropriate for the Trustee to fund the costs of the civil action brought by the employees in District Court was based upon a misinterpretation of the decision of this Court in Caplin v. Marine Midland Grace Trust Company, 406 U.S. 416 (1972). [6] Secondly, the decision of the Fourth Circuit Court of Appeals to uphold the reversal by the District Court of the funding orders of the Bankruptcy Court not only places the Fourth Circuit in conflict with the decision of the Ninth

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6 See Petition at 16 - 18.

Circuit Court of Appeals in In Re Equity Funding Corporation of America, 519 F.2d 1274 (9th Cir. 1975), but also brings the Fourth Circuit into conflict with its own decision in In Re Farrington Manufacturing Company, 540 F.2d 653 (4th Cir. 1976).[7] Respondent believes that each of the above arguments, standing alone, provides a sufficient basis for the granting of the Petition. A consideration of these arguments as a whole makes the granting of the Petition that much more compelling.

The Respondent's primary purpose in filing this Memorandum is to fully advise the Court of the reasons for which the Respondent sought the funding orders from the Bankruptcy Court. It should first be

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7 Id. at 18 - 20.

noted that at all times subsequent to the completion of his Rule 10-208 investigation, the Trustee has supported the funding by the Debtors of the costs of a civil action brought in District Court on behalf of the employees aggrieved by the mismanagement of the profit-sharing plan.[8] Furthermore, it remains the intention of the Trustee to apply for an order permitting him to assist in the defraying of such costs should this Court so allow. At the time of the original funding order of July 21, 1978, the Respondent fully recognized that there was a potential that the employees would become claimants in the Bankruptcy Court at some future

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8 The trustee joined with the Petitioners in the Court below in supporting the allowance of funding by the trustee of the costs of the employees' suit.

date.[9] The employees have attempted to become claimants in the Bankruptcy Court by way of multiple proofs of claim filed on behalf of the employees by the Petitioners in this proceeding. By seeking Orders which permitted him to assist the employees in the funding of their civil action in District Court, the Respondent hopes to reduce potential claims against the debtors by an amount which conceivably might total approximately 2.8 million dollars. Thus the debtors would derive a substantial benefit from the Trustee's funding of the costs of the employees' action in District Court.

Poor employee morale became a sizeable problem following the Debtors'

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[9] Id at 6, 19a.

filing for corporate reorganization.[10] The Trustee believes that the "morale of the Debtors' employees would be vitally improved" through the prosecution of an action against the parties responsible for the losses to the profit sharing plans. [11] Because the employees are alleged to have insufficient resources to defray the costs of a District Court action, the Trustee believes it to be in the best interest of the Debtors that an Order issue permitting the Companies to fund the costs of the employees' litigation. The Trustee believed this to be true at the time he filed his Rule

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[10] See Appendix to the Appellant's Brief in the proceeding below at page 98.

[11] Id. at 99.

10-208(a) Report and he maintains that belief at this time.

CONCLUSION

For the reasons stated above, and for the reasons set forth in the Petition not inconsistent with this Memorandum, this Court should grant the Petition for a Writ of Certiorari.

Respectfully submitted,

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No. 80-1755

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ALEXANDER L. STEVAS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

GEORGE W. FULK, THOMAS W. SHELTON, and WILLIAM F. SUDDETH,

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Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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PETITIONERS' REPLY MEMORANDUM

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PETITIONERS' REPLY MEMORANDUM

I. RESPONDENTS' CHALLENGE TO THE STANDING OF THE PETITIONERS IS UNSOUND

A new issue raised in respondents' opposing brief in No. 80-1755 concerns the standing of petitioners to petition this Court for a writ of certiorari. *See* Respondents' Brief at 21-27. Briefly summarized, respondents' argument is that petitioners were not parties to the reorganization proceedings and were not aggrieved by the lower court's reversal of the bankruptcy court's order authorizing the trustee to pay the costs of their litigation. This argument is based on a fundamental

misunderstanding, *inter alia*, of the nature of Chapter X reorganization proceedings, as distinguished from regular bankruptcy proceedings.[1]

In a proceeding arising under Chapter X, "[t]he debtor, the indenture trustees, and *any creditor or stockholder of the debtor shall have the right to be heard on all matters* . . . ." 11 U.S.C. § 606 (1976) (emphasis added). This Court has stated that this provision creates an exception to the general rules pertaining to standing to be heard and to appeal in bankruptcy cases: "[Section] 206 of the Chandler Act . . . , contrary to the general bankruptcy procedure, grants any stockholder or creditor the right to be heard on all matters relating to corporate reorganizations. Courts have liberally construed this language as authorizing appeals." *Young* v. *Higbee Co.*, 324 U.S. 204, 210 (1945) (footnote omitted).[2]

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[1] None of the decisions cited by respondents in their argument on the standing issue involves proceedings under Chapter X. In fact, at least one of respondents' authorities comments upon the significant difference between Chapter X and other bankruptcy proceedings in the area of standing to appeal. 6 *Collier on Bankruptcy* Part 2 ¶ 9.23[2], at 1700-01 (14th ed. 1978).

[2] One of the decisions cited with approval by this Court in *Young* v. *Higbee Co.* held that shareholders and creditors need not intervene in the district court in order to have standing to appeal to the circuit court of appeals. Dana v. SEC, 125 F.2d 542, 543 (2d Cir. 1942) (per curiam) (panel of L. Hand, Chase, and Clark, JJ.). Rather, creditors and stockholders may appeal from any order deciding any matter in a Chapter X proceeding. *Id.* In a subsequent decision, the Third Circuit held that a creditor who made no appearance at the hearing before the district court pertaining to an alleged fraudulent transfer of the debtor's property to that creditor nevertheless had standing to appeal the district court's order requiring it to reconvey the property to the debtor. *In re* S. Jersey Land Corp., 361 F.2d 610, 614 (3d Cir. 1966). The law on this point was recently summarized by Judge Duffy of the Southern District of New York as follows: " '[T]he right to be heard' provided for in Section 206 and Rule 10-210(a)(1)

As a result of section 206, creditors and stockholders "are by statute parties to the case." 6 *Collier on Bankruptcy* Part 2 ¶ 9.23[1], at 1694 (14th ed. 1978). The record clearly establishes that petitioners are creditors[3] of the debtors herein. For purposes of Chapter X, the term "creditor" is simply defined as "the holder of any claim." 11 U.S.C. § 506(4) (1976). The term "claims" is defined to include "all claims of whatever character . . . whether or not such claims are provable under section 103 of this title and whether secured or unsecured, liquidated or unliquidated, fixed or contingent." *Id.* § 506(1).

As creditors and stockholders of the debtors, the defrauded employees have the same statutorily protected interest in the order in question as do respondents. In fact, all creditors and stockholders of the debtors have a very clear interest in the issues presented. If the bankruptcy judge's January 16 order is upheld, the trustee's expenditure of the debtors' funds for costs of the *Fulk* action is likely to result in a substantial reduction or elimination of the claims against the estate, as well as a substantial improvement in the viability of any plan of reorganization, and the prospects for financial recovery by all creditors and stockholders will there-

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includes the right of appeal even absent participation in the proceeding resulting in the order from which the appeal is taken." *In re* Duplan Corp., 450 F. Supp. 790, 792 (S.D.N.Y. 1978).

[3] The class plaintiffs' claims in *Fulk* against the debtors' directors, officers, and agents also could be claims against the debtors themselves. Indeed, the petitioners herein filed proofs of claims in the reorganization proceedings on September 14, 1979. Respondents' Brief at 13. Petitioners are also stockholders of the debtors, as a result of the distribution of Washington Group stock made by the terminated employee benefit plans to the participants of the plans.

fore be greatly enhanced.[4] As a result, the respondents' assertion that the defrauded employees "have no rights to seek this review" is without merit.

II. RESPONDENTS RELY UPON A DECISION OF THE BANKRUPTCY COURT WHICH HAS BEEN REVERSED ON APPEAL

Respondents have cited and appended to their opposing brief the entire text of an opinion written by the bankruptcy judge on May 15, 1980, which purported to disallow the claims filed in the Chapter X proceedings by petitioners. Respondents failed to report, however, that upon appeal by the petitioners and the United States Securities and Exchange Commission, the district court upheld petitioners' right to file claims in the Chapter X proceedings and reversed the bankruptcy judge's disallowance of those claims. Memorandum dated May 18, 1981.[5] Respondents also failed to disclose that the bankruptcy judge's May 15, 1980 order did not alter or rescind his January 16, 1979 order which is the subject of this petition. *See* Petition at 19a. Thus, the bankruptcy judge's now-reversed opinion and the unfounded statements contained therein should have no bearing on this Court's decision to grant certiorari in this case.

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[4] Far less substantial interests have been held to confer standing to appeal orders in reorganization proceedings. *See, e.g., In re* Wonderbowl, Inc., 515 F.2d 18, 19 (9th Cir.) (stockholder whose subordinated position renders his stock worthless nevertheless has standing to appeal order approving compromise in Chapter X proceeding), *cert. denied*, 423 U.S. 869 (1975).

[5] Attached hereto as Appendix A. This memorandum was transmitted to counsel by the clerk of the district court on May 19, 1981, but counsel had previously been advised by the district court, on several occasions, that it intended to reverse the bankruptcy judge on this issue.

III. RESPONDENTS MISINTERPRET PETITIONERS' ARGUMENT REGARDING THE DUTIES OF A REORGANIZATION TRUSTEE

Respondents argue that the reorganization trustee in this case could not be a "fiduciary" under the Employee Retirement Income Security Act of 1974 because the employee benefit plans at issue had been terminated or transferred to the Pension Benefit Guaranty Corporation prior to the bankruptcy court's appointment of the trustee. Respondents' Brief at 48-51. This argument is specious and irrelevant since it is clear under the bankruptcy law that a reorganization trustee stands in the shoes of the corporation he has been appointed to manage,[6] and the trustee here was merely carrying out the fiduciary duties of the corporation which had established and, during the period at issue in the proceeding below, had acted as a fiduciary with respect to the plans.

Respectfully submitted,

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June 1981

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[6] *See* 11 U.S.C. §§ 110(a), 586, and 587 (1976).

APPENDIX A

UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF NORTH CAROLINA
OFFICE OF THE CLERK

Post Office Box V-1

Greensboro, North Carolina 27402

CARMON J. STUART, Clerk

Telephone (919) 378-5347

May 19, 1981

TO: ALL COUNSEL OF RECORD

RE: C-80-342-G; Shelton and Collins, et al. v. Gilbert, et al.
(B-77-695 etc. Appeal)

Gentlemen:

Please see the attached memorandum dated May 18, 1981, of Judge Erwin's ruling on the appeals from the Bankruptcy Court Order dated May 15, 1980.

Your proposed judgment should be submitted to this office no later than *June 8* for coordination and forwarding to Judge Erwin.

Very truly yours,

/s/ Carmon J. Stuart
CARMON J. STUART

bf

Enclosure

UNITED STATES GOVERNMENT

memorandum

Date: May 18, 1981

/s/ Richard C. Erwin

Reply to
Attn of: Richard C. Erwin, U.S. District Judge

Subject: C-80-342-G; Shelton and Collins, et al. v. Gilbert, et al. (Appeal B-77-695 etc.)

To: Mr. Carmon J. Stuart
Clerk of Court

The Court is ruling as follows on the above-referenced appeal from the May 15, 1980 order of Judge Reynolds, Bankruptcy Judge:

(1) As to the Collins, et al. claim (filed September 14, 1979):

a. Reverse Judge Reynolds as to Webster A. Collins, Herbert R. Morrison and Helen O. Morrison, W. O. Gregory, and Glen A. Wilkinson.

b. Affirm as to "[Names and addresses of all other similarly situated shareholders of the Debtors known to or reasonably ascertainable by the Trustee]."

(2) As to the Shelton, et al. claim (filed September 14, 1979):

a. Reverse Judge Reynolds as to Thomas W. Shelton, William F. Suddeth, and George W. Fulk.

b. Affirm as to "[Names and addresses of all other similarly situated employees and for-

mer employees of the Debtors known to or ascertainable by the Trustee]," *but* remand to Judge Reynolds with instructions that he consider the Proof of Multiple Claims filed October 5, 1979 by George W. Fulk in his capacity as fiduciary with respect to various profit sharing, pension, and retirement plans listed in the claim.

(3) The Court requests that all parties file a proposed judgment within twenty (20) days of this date in light of the above.

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